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CERTIFICATION FROM  
UNITED STATES DISTRICT COURT  
WESTERN DISTRICT OF WASHINGTON AT SEATTLE  
MASTER FILE No. C06-0794 RSL

In re F5 NETWORKS, INC. DERIVATIVE ACTION LITIGATION

GLENN HUTTON, et al.,  
*Plaintiffs,*

vs.

JOHN McADAM, et al.,  
*Defendants.*

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**APPENDIX IN SUPPORT OF PLAINTIFFS'  
BRIEF ON CERTIFIED QUESTION**

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05/22/2006	<i>Options Pricing – Hindsight is 20/20</i> , Merrill Lynch Report on Semiconductor Industry (Record No. 54, Ex. 4)	PA:093
	Senate Journal, 1989, Volume 2, Regular Session and First and Second Special Sessions, Fifty-First Legislature of the State of Washington	PA:118

1 THE HONORABLE ROBERT S. LASNIK

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8 UNITED STATES DISTRICT COURT  
9 WESTERN DISTRICT OF WASHINGTON  
10 AT SEATTLE

11  
12 In re F5 NETWORKS, INC. DERIVATIVE  
13 LITIGATION

) Master File No. C-06-0794-RSL

) AMENDED CONSOLIDATED VERIFIED  
14 SHAREHOLDERS DERIVATIVE  
15 COMPLAINT

16 DEMAND FOR JURY TRIAL  
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AMENDED CONSOLIDATED VERIFIED  
SHAREHOLDERS DERIVATIVE COMPLAINT  
(C-06-0794-RSL)

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## INTRODUCTION

1. This is a shareholders derivative action on behalf of nominal defendant F5 Networks, Inc. ("F5" or the "Company") against its entire Board of Directors and certain current and former top officers. Defendants are F5's Chief Executive Officer ("CEO"), John McAdam; Chief Financial Officer ("CFO"), Andy Reinland; Chief Accounting Officer, John Rodriguez; General Counsel, Joann M. Reiter; Senior Vice President of Business Operations, Edward J. Eames; Senior Vice President and General Manager, Jeff Pancottine; Senior Vice President of Worldwide Sales, Tom Hull; former Senior Vice President of Product Development, Brett L. Helsel; former Senior Vice President of Sales and Services, Steven Goldman; former Chairman and CEO, Jeffrey S. Hussey; former Director and Chief Technology Officer, Carlton Amdahl; former CFO, Steven B. Coburn; and its Directors – Alan J. Higginson, Karl D. Guelich, Keith D. Grinstein, Rich Malone, and A. Gary Ames.

2. Between 1999 and March 2006, defendants engaged in a secret and undisclosed scheme to grant in-the-money stock options to themselves and other F5 insiders by backdating stock option grants to coincide with monthly low closing prices for the Company's common stock and falsify F5's financial and proxy statements for 1999-2006. Indeed, 12 of 26 stock option grants to F5's directors and top officers fell on the 2 most favorable dates, *i.e.*, the lowest (9) or second lowest (3) monthly closing price of F5's common stock. The odds of this happening are 1 in 2,764,905. In fact, the odds of hitting the lowest price of the month 9 out of 26 times is 1 in 391,905.

3. A stock option granted to a director or employee of a corporation allows the recipient to purchase company stock at a specified price – referred to as the "exercise price" – for a specified period of time. Stock options are granted as part of employee compensation packages as a means to create incentives that will boost profitability and stock value. When the recipient exercises the option, she purchases the stock from the company at the exercise price, regardless of the stock's market price at the time the option is exercised. Exercise prices are almost universally set at the fair market value of the stock on the date of the option grant. This method ensures that employees have

1 an incentive to increase the company's stock value, since their options are worthless unless the stock  
2 price increases.

3 4. An option is backdated if the stated date of the option is earlier than the date that the  
4 option was actually granted. Backdating allows a company to look back in time to choose a date  
5 when the company's stock price (and thus the exercise price) was lower than it was on the true grant  
6 date. Backdating also allows a company retrospectively to choose a *particularly favorable* grant  
7 date (*i.e.*, a date on which the stock price is particularly low). Options that were backdated in this  
8 manner are thus already valuable when they are received (they are "in the money"), even if the stock  
9 price does not go up at all after the date of the grant. When these options are exercised, the  
10 employee pays less than he or she should for company stock, and the company receives less money  
11 than it should for the stock.

12 5. By engaging in this backdating scheme, defendants were able to conceal that F5 was  
13 not recording material compensation expenses thereby materially overstating the Company's net  
14 income and earnings per share and understating its net losses and losses per share. Defendants  
15 collectively realized over \$161.2 million in illicit compensation through the exercise of illegally  
16 backdated options grants and subsequent sale of F5 stock.

17 6. On October 25, 2006, F5 announced that an internal investigation had uncovered  
18 irregularities related to the issuance of certain stock option grants made between 1999 and March  
19 2006. F5 further disclosed that, because the Company will likely need to restate its historical  
20 financial statements for fiscal 1999-2005 "to record additional non-cash, stock-based compensation  
21 expense" related to past stock option grants, "the [C]ompany's financial statements and earnings  
22 releases and similar financial communications relating to fiscal periods commencing on or after  
23 October 1, 1998, which is the first day of the [C]ompany's fiscal year 1999, and through the date of  
24 this release should no longer be relied upon." The announcement specifically noted the Company's  
25 findings:

26 Based on its analysis to date, the company anticipates that it may be required to  
record additional non-cash, stock-based compensation expense of up to \$30 million,

1 in the aggregate, for fiscal years 1999 through 2006, to restate its financial statements  
2 for fiscal years 1999 through 2005, and to amend its financial statements for the first  
half of fiscal 2006. . . .

3 In light of the expected adjustments described above, the company's financial  
4 statements and earnings releases and similar financial communications relating to  
5 fiscal periods commencing on or after October 1, 1998, which is the first day of the  
company's fiscal year 1999, and through the date of this release should no longer be  
relied upon.

6 7. Then, on November 8, 2006, F5 announced the completion of the internal  
7 investigation into defendants' backdating scheme. In an attempt to avoid liability for their blatant  
8 backdating scheme, defendants caused the Company to minimize the key findings of the  
9 investigation, including: (i) that "the recorded grant dates for certain stock options granted during  
10 fiscal years 1999 through March 2006 should not be relied upon as the measurement date for  
11 accounting purposes and that the accounting treatment used for the vesting of certain stock options  
12 was incorrect"; (ii) that "F5 will be required to record an additional non-cash, stock-based  
13 compensation expense of approximately \$22.9 million, in the aggregate, for fiscal years 1999  
14 through 2006"; and (iii) that "the Company should restate its financial statements for fiscal years  
15 1999 through 2005 and its financial statements for the first two quarters of fiscal 2006, to reflect the  
16 non-cash, stock-based compensation expense described above."

17 8. The Company also announced that "[t]hrough September 30, 2006, F5 has spent  
18 approximately \$7.0 million in legal and accounting fees related to this inquiry," and that its General  
19 Counsel, Reiter, had "resigned" in the wake of the disclosures regarding defendants' secret  
20 backdating scheme.

21 9. Because F5 is only obligated to disclose option grants to certain executive officers in  
22 its proxy filings, the full breadth of unlawful stock options and false financial reporting scheme is  
23 not yet known. However, many stock option grants to F5's directors and top officers came at the  
24 monthly lows in F5's share price.

25 10. Before the recent disclosure of defendants' stock option backdating scheme, F5 stock  
26 traded at prices as high as \$158 per share, propelled in large part by the admittedly false financial

1 statements that defendants had caused F5 to issue. While the price of F5 stock was artificially  
2 inflated, defendants engaged in a massive insider trading bailout, selling more than \$161.2 million  
3 worth of F5 stock in violation of securities laws. For example, F5's CEO, McAdam, alone sold  
4 more than 1.2 million F5 shares valued at over \$42.9 million, while F5's former Chairman and CEO,  
5 Hussey, sold 478,000 shares for \$25.8 million; F5's Senior Vice President and General Manager,  
6 Pancottine, sold 475,878 shares for \$19.1 million; F5's Senior Vice President of Business  
7 Operations, Eames, sold 386,146 shares for \$16.6 million; F5's Chief Financial Officer, Coburn,  
8 sold 365,000 shares for \$14.9 million; F5's Senior Vice President of Sales and Services, Goldman,  
9 sold 352,500 shares for proceeds of \$10.5 million; F5's General Counsel, Reiter, sold 226,491 shares  
10 for \$8.4 million; and F5's Senior Vice President of Product Development, Helsel, sold 289,703  
11 shares for \$8.2 million.

12 11. F5's directors also profited handsomely from the secret backdating scheme. For  
13 example, F5 Director Higginson sold 156,300 F5 shares valued at over \$6.6 million, while his fellow  
14 Board and Audit and Compensation Committee members, Guelich and Grinstein, sold 70,880 shares  
15 for \$3.1 million and 62,500 shares for \$2.8 million, respectively. All three of these F5 directors  
16 received backdated options on January 1, 2001, April 20, 2001 and May 6, 2002 (*see* ¶¶80-83, 86-  
17 87, *infra*). F5 director Ames also sold 10,000 F5 shares for at least \$548,800 in unlawful insider  
18 trading proceeds. Ames, Guelich, Grinstein, Higginson and Malone were members of the  
19 Compensation Committee of the F5 Board of Directors, which approved stock options backdated as  
20 a part of defendants' scheme that commenced in 1999 and continued seamlessly and undisclosed  
21 until 2006.

22 12. By this action, plaintiffs seek to remedy the substantial damage and injuries inflicted  
23 upon F5 by defendants' secret backdating scheme. By approving backdated grants to themselves  
24 and F5's executives and employees, the F5 Board of Directors: (i) diverted hundreds of millions of  
25 dollars of corporate assets to top F5 insiders; (ii) caused F5 to materially understate its compensation  
26 expenses and materially overstate its net income or materially understate its net loss, exposing F5 to

1 potential liability for violations of the securities laws; (iii) subjected F5 to substantial investigative  
2 costs and massive potential liability from regulators, including the Securities and Exchange  
3 Commission ("SEC") and the Internal Revenue Service ("IRS"); (iv) damaged F5's credibility with  
4 shareholders and business partners alike; (v) subjected F5 to the cost of restating at least six years of  
5 financial statements; and (vi) exposed F5 to possible delisting by the NASDAQ stock market.  
6 Plaintiffs, on behalf of F5, seek to recover defendants' ill-gotten profits and to institute corporate  
7 governance reforms to ensure F5's directors' and officers' compliance with the high legal  
8 requirements applicable to persons serving as the leaders of a major American public corporation.

### 9 JURISDICTION AND VENUE

10 13. The claims asserted herein arise under §§10(b), 14(a) and 20(a) of the Securities  
11 Exchange Act of 1934 ("Exchange Act"), 15 U.S.C. §§78j(b), 78n(a) and 78t(a), and Rule 10b-5, 17  
12 C.F.R. §240.10b-5, promulgated thereunder, and under Washington law for breach of fiduciary duty,  
13 abuse of control, constructive fraud, corporate waste, unjust enrichment and gross mismanagement.  
14 In connection with the acts, conduct and other wrongs complained of herein, defendants, directly or  
15 indirectly, used the means and instrumentalities of interstate commerce, the United States mail and  
16 the facilities of a national securities market.

17 14. This Court has subject matter jurisdiction pursuant to §27 of the Exchange Act, 15  
18 U.S.C. §78aa, as well as 28 U.S.C. §§1331 and 1337. This Court also has supplemental jurisdiction  
19 over the state law claims asserted herein pursuant to 28 U.S.C. §1367.

20 15. This action is not a collusive one to confer jurisdiction on a court of the United States  
21 which it would not otherwise have.

22 16. Venue is proper in this District pursuant to §27 of the Exchange Act, 15 U.S.C.  
23 §78aa, as well as 28 U.S.C. §1391(b). Many of the acts charged herein, including the preparation  
24 and dissemination of materially false and misleading information, occurred in substantial part in this  
25 District. F5 is located in and conducts its business in this District. Further, defendants conduct  
26



1 business in this District, and certain of the defendants are citizens of Washington and reside in this  
2 District.

3 **PARTIES**

4 17. **Lead Plaintiff Locals 302 and 612 of the International Union of Operating**  
5 **Engineers-Employers Construction Industry Retirement Trust** has held F5 stock during the  
6 following time periods: November 8, 1999-June 7, 2002; April 30, 2004-June 27, 2007; and July 9,  
7 2007 to the present.

8 18. **Plaintiff Glenn Hutton** acquired F5 stock on January 23, 2003, and has held F5  
9 stock continuously to the present, including at the time he filed his complaints.

10 19. **Plaintiff David Sommer** acquired F5 stock on February 14, 2000, and has held F5  
11 stock continuously to the present, including at the time he filed his complaint.

12 20. **Plaintiff Lawrence Barone** acquired F5 stock in 2000, and has held F5 stock  
13 continuously to the present, including at the time he filed his complaint.

14 21. **Nominal defendant F5 Networks, Inc.** ("F5" or the "Company") is a Washington  
15 corporation with its principal place of business located at 401 Elliott Avenue West, Seattle,  
16 Washington 98119. F5 is a provider of application delivery networking products that improve the  
17 performance, availability and security of applications running on networks that use the Internet  
18 Protocol (IP). IP traffic between servers running applications and clients using those applications  
19 passes through F5's products where the content is inspected to ensure that it is delivered securely  
20 and in a way that optimizes the performance and availability of both the network and the  
21 applications.

22 22. **Defendant John McAdam** ("McAdam") has served as a Chief Executive Officer  
23 ("CEO"), President, and Director of F5 since July 2000. As an executive and member of the Board  
24 of Directors, McAdam granted and received backdated stock options at issue in this case. McAdam  
25 personally and financially benefited from the backdated stock option scheme particularized herein.  
26 He received at least 880,000 backdated options worth at least \$12 million. McAdam has sold at least

1 1.2 million shares of his personal F5 stock, for unlawful insider trading proceeds of at least \$42.9  
2 million. McAdam also signed certifications pursuant to the Sarbanes-Oxley Act falsely stating under  
3 oath that F5's financial reports fairly presented, in all material respects, F5's financial condition and  
4 results of operations. McAdam assisted in the preparation of F5's annual and quarterly reports and  
5 signed F5's annual financial reports for fiscal 2000-2005, which now must be restated to correct the  
6 accounting irregularities caused by defendants' backdating scheme. He also reviewed, approved and  
7 helped prepare each proxy statement F5 issued since at least July 2000.

8 23. Before he joined F5 in July 2000, McAdam was the CEO of Sequent Computer  
9 Systems, a data-system developer in Beaverton, Oregon. In four years at Sequent, McAdam had the  
10 good fortune to receive suspiciously well-timed stock-option grants – just as he has at F5. Sequent's  
11 SEC filings show three of McAdam's last five option grants were dated when the stock was at a  
12 monthly low. In one instance, a grant was dated October 28, 1998, just prior to a sharp price  
13 increase in November 1998.

14 24. **Defendant Alan J. Higginson** ("Higginson") has served as a Chairman of F5 since  
15 April 2004, and as a Director since May 1996. Higginson served on the Compensation Committee  
16 from at least December 1999 to April 2004. He also served as a member of the Audit Committee  
17 from at least 1999 until October 2003. As a member of the Board of Directors and Compensation  
18 Committee, Higginson granted and received backdated stock options at issue in this case. Higginson  
19 personally and financially benefited from the backdated stock option scheme particularized herein.  
20 He received at least 37,500 backdated options worth at least \$359,550. Higginson has sold at least  
21 156,300 shares of his personal F5 stock, for unlawful insider trading proceeds of at least \$6.6  
22 million. Higginson assisted in the preparation of F5's annual and quarterly reports since at least the  
23 Company's Initial Public Offering in June 1999. Higginson signed F5's annual financial reports for  
24 fiscal 1999-2005 which now must be restated to correct the accounting irregularities caused by  
25 defendants' backdating scheme. He also reviewed, approved and helped to prepare each proxy  
26 statement F5 issued since at least June 1999. Higginson holds a B.S. in Commerce and an M.B.A.

1 from the University of Santa Clara, and, therefore, is familiar with the accounting rules applicable to  
2 stock-based compensation, including APB No. 25.

3       25.     **Defendant Karl D. Guelich, C.P.A.** ("Guelich") has served as a Director of F5 since  
4 June 1999, and as a member of both the Audit and Compensation Committees continuously since  
5 1999. As a member of the Board of Directors and Compensation Committee, Guelich granted and  
6 received backdated stock options at issue in this case. Guelich personally and financially benefited  
7 from the backdated stock option scheme particularized herein. He received at least 37,500  
8 backdated options worth at least \$359,550. Guelich has sold at least 70,880 shares of his personal  
9 F5 stock, for unlawful insider proceeds of at least \$3.1 million. Guelich assisted in the preparation  
10 of F5's annual and quarterly reports since at least June 1999. Guelich signed F5's annual financial  
11 reports for fiscal 1999-2005 which now must be restated to correct the accounting irregularities  
12 caused by defendants' backdating scheme. He also reviewed, approved and helped to prepare each  
13 proxy statement F5 issued since at least June 1999. Guelich is a C.P.A., holds a B.S. in Accounting  
14 from Arizona State University and, therefore, is familiar with the rules applicable to stock-based  
15 compensation, including APB No. 25.

16       26.     **Defendant Keith D. Grinstein, Esq.** ("Grinstein") has served as a Director of F5  
17 since December 1999, and as a member of the Audit Committee continuously since 1999. He also  
18 served on the Compensation Committee from at least December 1999 to October 2003, and  
19 continuously since July 2004. As a member of the Board of Directors and Compensation  
20 Committee, Grinstein granted and received backdated stock options at issue in this case. Grinstein  
21 personally and financially benefited from the backdated stock option scheme particularized herein.  
22 He received at least 37,500 backdated options worth at least \$359,550. Grinstein has sold at least  
23 62,500 shares of his personal F5 stock, for unlawful insider proceeds of at least \$2.8 million.  
24 Grinstein assisted in the preparation of F5's annual and quarterly reports since at least December  
25 1999. Grinstein signed F5's annual financial reports for fiscal 2000-2005 which now must be  
26 restated to correct the accounting irregularities caused by defendants' backdating scheme. He also

1 reviewed, approved and helped prepare each proxy statement F5 issued since at least December  
2 1999.

3       27.     **Defendant Rich Malone** ("Malone") has served as a Director of F5 since August  
4 2003, and as a member of the Compensation Committee from October 2003 to July 2004. As a  
5 member of the Board of Directors, Malone assisted in the preparation of F5's annual and quarterly  
6 reports since at least August 2003. Malone signed F5's annual financial reports for fiscal 2003-2005  
7 which now must be restated to correct the accounting irregularities caused by defendants' backdating  
8 scheme. He also reviewed, approved and helped to prepare each proxy statement F5 issued since at  
9 least August 2003.

10       28.     **Defendant A. Gary Ames** ("Ames") has served as a Director of F5 since July 2004,  
11 and as a member of the Compensation Committee since July 2004. As a member of the Board of  
12 Directors and Compensation Committee, Ames assisted in the preparation of F5's annual and  
13 quarterly reports since at least July 2004. Ames signed F5's annual financial reports for fiscal 2004-  
14 2005 which now must be restated to correct the accounting irregularities caused by defendants'  
15 backdating scheme. He also reviewed, approved and helped to prepare each proxy statement F5  
16 issued since at least July 2004. Defendant Ames personally and financially benefited from the  
17 undisclosed backdating scheme by selling at least 10,000 shares of his personal F5 stock, for  
18 unlawful insider trading proceeds of at least \$548,800.

19       29.     **Defendant Joann M. Reiter, Esq.** ("Reiter") has served as Vice President of F5  
20 since 2000, Corporate Secretary since July 1999, and as General Counsel since April 1998. On or  
21 about November 8, 2006, Reiter "resigned" in the wake of disclosures regarding the backdating  
22 scheme. As General Counsel of F5, Reiter approved and/or received backdated stock options at  
23 issue in this case. Reiter personally and financially benefited from the backdated stock option  
24 scheme particularized herein. She received at least 177,916 backdated options worth at least \$2.6  
25 million. Reiter has sold at least 226,491 shares of her personal F5 stock, for unlawful insider  
26 proceeds of at least \$8.4 million. Reiter assisted in the preparation of F5's annual and quarterly

1 reports since the Company's Initial Public Offering in June 1999. She also reviewed, approved and  
2 helped to prepare each proxy statement F5 issued since at least 1999. Reiter holds a J.D. from the  
3 University of Washington, and, therefore, is familiar with the legal and accounting requirements for  
4 the reporting of stock-based compensation, including APB No. 25.

5       30.     **Defendant Carlton Amdahl** ("Amdahl") served as a Director of F5 from at least  
6 May 1998 to January 2001 and as Chief Technical Officer from at least February 2000 to January  
7 2001. As a member of the Board of Directors and an executive of F5, Amdahl approved and/or  
8 received backdated stock options at issue in this case. Amdahl personally and financially benefited  
9 from the backdated stock option scheme particularized herein. He received 150,000 backdated  
10 options worth at least \$12,621,000. Defendant Amdahl has sold at least 10,000 shares of his F5  
11 stock, for unlawful insider trading proceeds of at least \$520,300. Amdahl assisted in the preparation  
12 of F5's annual and quarterly reports from at least 2000 until 2001. Amdahl signed F5's annual  
13 financial report for fiscal 1999 which must now be restated to correct the accounting irregularities  
14 caused by defendants' backdating scheme. He also reviewed, approved and helped to prepare each  
15 proxy statement F5 issued between at least 1999 and January 2001. Amdahl, a Stanford University  
16 Sloan Fellow, holds an M.S. in Management from Stanford University, and, therefore, is familiar  
17 with the accounting requirements for the reporting of stock-based compensation, including APB No.  
18 25.

19       31.     **Defendant Steven Goldman** ("Goldman") has served as Senior Vice President of  
20 Sales and Services of F5 from July 1999 to August 2003, and Vice President of Sales, Marketing and  
21 Services from July 1997 to July 1999. Goldman received backdated stock options at issue in this  
22 case and personally and financially benefited from the backdated stock option scheme particularized  
23 herein. He received 215,000 backdated options worth at least \$2.3 million. Defendant Goldman has  
24 sold at least 352,500 shares of his F5 stock, for unlawful insider trading proceeds of at least \$10.5  
25 million. Goldman assisted in the preparation of F5's annual and quarterly reports since at least 1999.  
26 He also reviewed, approved and helped to prepare each proxy statement F5 issued since at least

1 1999. Goldman holds a B.A. in Economics from the University of California at Berkeley, and,  
2 therefore, is familiar with the accounting requirements for the reporting of stock-based  
3 compensation, including APB No. 25.

4 32. **Defendant Brett L. Helsel** ("Helsel") served as Senior Vice President of Product  
5 Development of F5 from February 2000 until he resigned and Vice President of Product  
6 Development and Chief Technology Officer from May 1998 to February 2000. Helsel received  
7 backdated stock options at issue in this case and personally and financially benefited from the  
8 backdated stock option scheme particularized herein. He received 80,000 backdated options worth  
9 at least \$660,000. Defendant Helsel has sold at least 289,703 shares of his F5 stock, for unlawful  
10 insider trading proceeds of at least \$8.2 million. Helsel also assisted in the preparation of F5's  
11 annual and quarterly reports between June 1999 and December 2001. He also reviewed, approved  
12 and helped to prepare each proxy statement F5 issued between 1999-2001.

13 33. **Defendant Jeff Pancottine** ("Pancottine") has served as Senior Vice President and  
14 General Manager of F5 since June 2004 and as Senior Vice President of Marketing and Business  
15 Development since October 2000. Pancottine received backdated stock options at issue in this case  
16 and personally and financially benefited from the backdated stock option scheme particularized  
17 herein. He received 265,000 backdated options worth at least \$3.4 million. Defendant Pancottine  
18 has sold at least 475,878 shares of his F5 stock, for unlawful insider trading proceeds of at least  
19 \$19.1 million. Pancottine assisted in the preparation of F5's annual and quarterly reports since at  
20 least October 2000. He also reviewed, approved and helped to prepare each proxy statement F5  
21 issued since at least October 2000.

22 34. **Defendant Tom Hull** ("Hull") has served as Senior Vice President of Worldwide  
23 Sales of F5 since October 2003. Hull received backdated stock options at issue in this case and  
24 personally and financially benefited from the backdated stock option scheme particularized herein.  
25 He received 40,000 backdated options worth at least \$1.01 million. Defendant Hull has sold at least  
26 50,000 shares of his F5 stock, for unlawful insider trading proceeds of at least \$892,000. Hull

1 assisted in the preparation of F5's annual and quarterly reports since at least October 2003. He also  
2 reviewed, approved and helped to prepare each proxy statement F5 issued since at least October  
3 2003.

4       **35. Defendant Steven B. Coburn** ("Coburn") served as Vice President of Finance and  
5 Chief Financial Officer of F5 from May 2001 until 2005. Coburn received backdated stock options  
6 at issue in this case and personally and financially benefited from the backdated stock option scheme  
7 particularized herein. He received 165,000 backdated options worth at least \$2.6 million. Coburn  
8 has sold at least 365,000 shares of his F5 stock, for unlawful insider trading proceeds of at least  
9 \$14.9 million. Coburn assisted in the preparation of F5's annual and quarterly reports from at least  
10 2001 to 2005. Coburn signed F5's annual financial reports for fiscal 2000-2004 which now must be  
11 restated to correct the accounting irregularities caused by defendants' backdating scheme. Coburn  
12 also signed certifications pursuant to the Sarbanes-Oxley Act falsely stating under oath that F5's  
13 financial reports fairly presented, in all material respects, F5's financial condition and results of  
14 operations. Coburn received a B.A. in Accounting from Southern Illinois University, and, therefore,  
15 is familiar with the accounting rules applicable to stock-based compensation, including APB No. 25.

16       **36. Defendant Edward J. Eames** ("Eames") has served as Senior Vice President of  
17 Business Operations of F5 since January 2001 and as Vice President of Professional Services from  
18 October 2000 to January 2001. Eames received backdated stock options at issue in this case and  
19 personally and financially benefited from the backdated stock option scheme particularized herein.  
20 He received 260,000 backdated options worth at least \$3.5 million. Defendant Eames has sold at  
21 least 386,146 shares of his F5 stock, for unlawful insider trading proceeds of at least \$16.6 million.  
22 Eames assisted in the preparation of F5's annual and quarterly reports since at least January 2001.

23       **37. Defendant Andy Reinland** ("Reinland") has served as Senior Vice President and  
24 Chief Financial Officer of F5 since October 25, 2005, and Vice President of Finance prior to that  
25 time. Defendant Reinland personally and financially benefited from the undisclosed backdating  
26 scheme by selling at least 18,933 shares of his personal F5 stock, for unlawful insider trading

1 proceeds of at least \$1.1 million. Reinland assisted in the preparation of F5's annual and quarterly  
2 reports since at least 1999. Reinland holds a B.A. in Business from Washington State University  
3 and is, therefore, familiar with the accounting rules applicable to stock-based compensation,  
4 including APB No. 25.

5       38.     **Defendant Jeffrey S. Hussey** ("Hussey") served as Chairman of F5 from 1996 to  
6 2002, and as Chief Executive Officer from February 1996 to July 2000. As a member of the Board  
7 of Directors and an executive of F5, Hussey approved and/or received backdated stock options at  
8 issue in this case. Hussey personally and financially benefited from the backdated stock option  
9 scheme particularized herein. He received 70,000 backdated options worth at least \$490,000.  
10 Defendant Hussey has sold at least 478,000 shares of his F5 stock, for unlawful insider trading  
11 proceeds of at least \$25.8 million. Hussey assisted in the preparation of F5's annual and quarterly  
12 reports since at least 1999-2002. Hussey signed F5's annual financial reports for fiscal 1999-2003  
13 which now must be restated to correct the accounting irregularities caused by defendants' backdating  
14 scheme. He also reviewed, approved and helped to prepare each proxy statement F5 issued since at  
15 least 1999 to 2002. Hussey holds an M.B.A. from the University of Washington and, therefore, is  
16 familiar with the accounting requirements for reporting stock-based compensation, including APB  
17 No. 25.

18       39.     **Defendant John Rodriguez** ("Rodriguez") has served as Senior Vice President and  
19 Chief Accounting Officer of F5 since October 25, 2005, and as Controller since 2001. Rodriguez  
20 personally and financially benefited from the undisclosed backdating scheme by selling at least  
21 10,287 shares of his personal F5 stock, for unlawful insider trading proceeds of at least \$595,564.  
22 Rodriguez assisted in the preparation of F5's annual and quarterly reports since at least 2001.  
23 Defendant Rodriguez signed F5's annual financial report for fiscal 2005 which now must be restated  
24 to correct the accounting irregularities caused by defendants' backdating scheme. Rodriguez also  
25 signed certifications pursuant to the Sarbanes-Oxley Act falsely stating under oath that F5's financial  
26 reports fairly presented, in all material respects, F5's financial condition and results of operations.



1 He also reviewed, approved and helped to prepare each proxy statement F5 issued since at least  
2 2001. Rodriguez holds a B.S. in Business from the University of Washington, and, therefore, is  
3 familiar with the accounting requirements for reporting stock-based compensation.

4 40. Each of the defendants is sued individually as a conspirator and aider and abettor, as  
5 well as in his or her capacity as an officer and/or director of F5, and the liability of each arises from  
6 the fact that he or she has engaged in all or part of the unlawful acts, plans, schemes or transactions  
7 complained of herein.

#### 8 **THE FIDUCIARY DUTIES OF F5'S DIRECTORS AND OFFICERS**

9 41. As F5's directors and officers, defendants owed F5 fiduciary duties, including duties  
10 of good faith, fair dealing, honesty and loyalty, in the performance of their responsibilities with  
11 respect to the management and administration of the affairs of F5, as well as the duty of full and  
12 candid disclosure of all material facts related thereto.

13 42. In addition, defendants owed to F5 the duty to ensure that its shareholder reports  
14 about the Company and its business and finances were accurate, complete and truthful and not in any  
15 way false and/or materially misleading. The conduct of F5's executives and directors who engaged  
16 in unlawful insider trading in violation of the securities laws, as well as their fiduciary duties of good  
17 faith and loyalty, has been ratified by F5's Board of Directors, which failed to take action against  
18 them.

19 43. To discharge their duties, defendants were required to exercise good faith and  
20 reasonable diligence in the supervision of F5's business and financial affairs. By virtue of these  
21 obligations, defendants were required, among other things to:

22 (a) in good faith, manage, conduct, supervise and direct the business and affairs  
23 of F5 in accordance with state and federal laws and regulations and the Articles of Incorporation and  
24 By-Laws of F5;

25 (b) exercise reasonable control and supervision over the officers and employees  
26 of F5;

1 (c) exercise good faith in evaluation of the prudence and soundness of policies  
2 and practices proposed to be undertaken by F5;

3 (d) ensure that F5 did not engage in unsafe, imprudent or unsound practices and  
4 that F5 complied with all applicable laws and regulations;

5 (e) establish guidelines and policies adequately governing the structure and  
6 organization of the Company's operations;

7 (f) establish guidelines and policies adequately governing F5's stock option  
8 accounting and stock option granting practices;

9 (g) maintain a proper division of authority and responsibility among the officers  
10 and directors of F5 so as to prevent the dominance of any officer or director in the conduct of the  
11 business and affairs of F5;

12 (h) ensure that F5 did not engage in unsafe, imprudent or unsound practices and  
13 to become and remain informed as to how F5 was, in fact, operating;

14 (i) maintain and implement an adequate and functioning system of internal  
15 financial and accounting controls, such that F5's assets would be safeguarded, its financial  
16 statements and information would be accurately recorded and reported, and corporate managers  
17 would be given prompt notice of serious problems or divergences so that risk to the corporation  
18 would be minimized; and

19 (j) supervise the preparation and filing of financial results and financial  
20 statements required by law from F5, including the Company's SEC reports, and to examine and  
21 evaluate any reports of examination, audits or other information required by law concerning the  
22 financial condition of F5 and to make full and accurate disclosure of all material facts concerning,  
23 among other things, each of the subjects and duties set forth above.

24 44. At all relevant times, defendants occupied positions with F5 or were associated with  
25 the Company in such a manner as to make them privy to confidential proprietary information  
26 concerning F5's business and finances, as well its accounting and stock option granting practices.

1 Because of these positions and such access, each of these defendants knew or recklessly disregarded  
2 that the adverse facts specified herein had not been disclosed to and were being concealed from F5  
3 shareholders and the public.

#### 4 **FACTUAL ALLEGATIONS**

5 45. In the late 1990s and early 2000s, F5 experienced rapid growth in both sales and the  
6 size of its operations. To recruit and retain key employees, F5, at the direction of its Board of  
7 Directors, made liberal use of stock options as a form of compensation. Each option gave the  
8 recipient the right to buy one share of F5 common stock from the Company at a set price, called the  
9 "exercise" or "strike" price, on a future date after the option vested. The option was "in-the-money"  
10 whenever the trading price of F5 common stock exceeded the option's exercise price. The option  
11 was "at-the-money" whenever the trading price of F5 common stock and the exercise price were the  
12 same. The option was "out-of-the-money" or "underwater" whenever the trading price of F5  
13 common stock was less than the exercise price.

14 46. Between 1999 and 2006, defendants continuously represented in proxy statements  
15 and other documents filed with the SEC that options granted to F5 executives and directors, whether  
16 statutory or non-qualified statutory options, were made with prices equal to the fair market value of  
17 F5 common stock on the date of the grant, *i.e.*, the closing price of F5 stock on the date the option  
18 was purportedly granted.

#### 19 **The F5 Stock Option Plans**

20 47. From the time it became a public company in June 1999 through 2006, F5 granted  
21 stock options to its officers and directors under the following plans: the Amended and Restated 1996  
22 Stock Option Plan ("1996 Plan"), the Amended and Restated 1998 Equity Incentive Plan ("1998  
23 Plan"), the 1999 Non-Employee Directors' Stock Option Plan ("1999 Director Plan"), and the 2000  
24 Equity Incentive Plan ("2000 Plan").

25 48. Each of the plans explicitly prohibited the backdating of stock option grants, requiring  
26 instead that grants be issued at 100% of the fair market value of F5 stock *on the date of the grant*,

1 or, in the case of Non-Qualified Stock Options ("NSOs"), allowing a grant to be discounted to as  
2 much as 50% of the fair market value of F5 stock *on the date of the grant*.<sup>1</sup> Without exception, in  
3 each proxy statement issued by F5 during the relevant period, the F5 directors represented to  
4 shareholders that option grants to executives and directors during the preceding year had been made  
5 at fair market value on the date the Board of Directors purportedly issued the grant and would  
6 continue to be made to such executives and directors at fair market value during the current year.

7 49. The Plans defined fair market value to be the closing sales price of a share of F5  
8 common stock as published by the principal national exchange on which F5's common stock was  
9 listed. *See, e.g.*, 1998 Plan, ¶2.

10 50. The stated purpose of F5's incentive stock option plans was to "attract and retain key  
11 employees" and to "provide incentives for such persons to exert maximum efforts for the success of  
12 the Company and its Affiliates." 1998 Plan, ¶1; 2000 Proxy at 12; 2001 Proxy at 15; 2004 Proxy at  
13 17 ("The Board of Directors believes that the 1998 Plan has contributed to strengthening the  
14 incentive of participating employees to achieve the objectives of the Company and its shareholders  
15 by encouraging employees to acquire a greater proprietary interest in the Company."); 2005 Proxy at  
16 18.

17 51. Each plan gave F5's Board of Directors or Compensation Committee full power to  
18 interpret and administer the plans and full authority to select the specific employees to whom awards  
19 would be granted under the plans, the type and amount of the award to be granted to such  
20 employees, the exercise prices of the grants, and the terms of the option agreements to be entered  
21 into with such employees. *See, e.g.*, 1998 Plan, ¶3 ("[t]he Plan shall be administered by the Board  
22 unless and until the Board delegates administration to a Committee or an Administrator. . . .").

23  
24 <sup>1</sup> While the Board of Directors is allowed to grant NSOs under the 1998 Plan at no less than 50% of fair market  
25 value, it is not allowed to retroactively choose the grant date. Thus, the Board is not permitted to look back in time to  
26 grant options on a date the exercise price happened to fall within 50% of the fair market value of F5 stock on the date the  
grant is actually issued. Rather, the shareholder-approved plan expressly states that a grant can only be made at 100%  
(or not less than 50%) of the fair market value of F5 stock *on the date of the grant*. *See, e.g.*, 2000 Proxy at 12.

1 Under F5's stock option plans, the Board of Directors or Compensation Committee was responsible  
2 for determining the exercise price of each option grant, within certain limitations. *See, e.g.*, 1998  
3 Plan, ¶3.

4 52. The basic terms of the plans remained unchanged during the relevant period.  
5 According to public disclosures, the per share price of all incentive options must be equal to the fair  
6 market value of F5 common stock on the date the option is granted. *See, e.g.*, 2000 Proxy at 10  
7 ("Stock options are typically granted at the current market price and will only have value if the  
8 Company's stock price increases over the exercise price."); 2001 Proxy at 6 (same); 2002 Proxy at  
9 11 (same); 2003 Proxy at 12 (same); 2004 Proxy at 14 (same); 2005 Proxy at 14 (same).

10 53. The 1996 Plan authorized the issuance of both incentive stock options and NSOs.  
11 However, the 1996 Plan required that "the per share exercise price for *any Option* granted . . . shall  
12 not be less than the fair market value per share of the Common Stock at the Date of Grant . . . ."  
13 1996 Plan, ¶5.3. Employees were eligible for either incentive options or NSOs under the 1996 Plan.  
14 *Id.*, ¶3. Non-employee directors are not entitled to receive NSOs under the 1996 Plan. *Id.*

15 54. The 1998 Plan also authorized the issuance of both incentive stock options and NSOs  
16 to both employees and non-employee directors. 1998 Plan, ¶¶1(a), 6. Under the 1998 Plan,  
17 incentive stock options could not be granted with an exercise price "less than one hundred percent  
18 (100%) of the Fair Market Value of the stock subject to the Option." *Id.*, ¶6(b). The 1998 Plan  
19 stated that the exercise price of a NSO "shall be not less than fifty percent (50%) of the Fair Market  
20 Value of the stock subject to the Option on the date the Option is granted." *Id.*, ¶6(c). However,  
21 defendants reported to the SEC that each of the NSOs at issue in this Complaint were granted at  
22 100% of fair market value on the purported grant date.

23 55. The 1999 Director Plan authorized the issuance of NSOs to non-employee directors.  
24 1999 Director Plan, ¶1. The 1999 Director Plan required that the "exercise price of each Option  
25 shall be one hundred percent (100%) of the Fair Market Value of the stock subject to the Option on  
26 the date the Option is granted." *Id.*, ¶7(b).

1           56.     The 2000 Plan authorized the issuance of NSOs to employees who were not officers  
2 or directors. 2000 Plan, ¶1. The 2000 Plan required that the “exercise price of each Option shall not  
3 be less than one hundred percent (100%) of the Fair Market Value of the stock subject to the Option  
4 on the date the Option is granted.” *Id.*, ¶6(b).

5           57.     All of the grants at issue involve NSOs. Reading the terms of all of the plans in  
6 conjunction, means that NSO grants issued to non-employee directors must be made pursuant to the  
7 1998 Plan or the 1999 Director Plan. NSO grants issued to directors who were also employees could  
8 be issued under the 1996 or 1998 Plans. NSO grants to employees who were neither officers nor  
9 directors could be issued under the 1996, 1998 or 2000 Plans.

10          58.     Therefore, non-employee, Directors Higginson, Guelich, Grinstein, Malone and Ames  
11 could have only been granted the NSOs at issue in this Complaint under the 1998 Plan or the 1999  
12 Director Plan. Director defendants McAdam, Reiter, Amdahl and Hussey were also employees of  
13 the Company and therefore could have only been granted the NSOs at issue in this Complaint under  
14 the 1996 or 1998 Plans. Employee defendants Reiter, Goldman, Helsel, Pancottine, Hull, Coburn,  
15 Eames, Reinland and Rodriguez were all officers of the Company and could only have been granted  
16 the NSOs at issue in this Complaint under the 1996 or 1998 Plans.

17 **F5's By-Laws**

18          59.     At all relevant times, the By-Laws of F5 authorized the Board of Directors or  
19 Compensation Committee to act formally on option grant proposals one of two ways: The Board of  
20 Directors or Compensation Committee could act without a formal meeting if all members of the  
21 Board or Committee consented in writing to the adoption of a resolution authorizing the action. This  
22 is “unanimous written consent.” Alternatively, the Board of Directors or Compensation Committee  
23 could act by holding a meeting at which a quorum of the Board or Committee members is present, if  
24 a majority of those present at the meeting approve the action.

1           60.     For many of the F5 option grants made during the relevant period, the Board of  
2 Directors and/or Compensation Committee acted through unanimous written consents, and not  
3 through a formal meeting of the Board of Directors or Compensation Committee members.

4 **The Backdating Analysis**

5           61.     For some time now, leading scholars have been interested in the unusual phenomena  
6 at companies around the country whereby corporate insiders repeatedly received stock option grants  
7 issued at or near the monthly low closing price for the company's stock. However, it was only  
8 recently that Merrill Lynch, the Center for Financial Research and Analysis ("CFRA") and *The Wall*  
9 *Street Journal* published academic analyses of stock option granting practices at various companies  
10 explaining that these extraordinary grants were due to backdating. The studies noted that prior to the  
11 enactment of the Sarbanes-Oxley Act ("SOX") in 2002, which requires companies to disclose stock  
12 option grants within two business days of the grant, stock option backdating was difficult, if not  
13 impossible, to detect.

14           62.     All of this changed when, on March 18, 2006, *The Wall Street Journal* printed an  
15 article revealing egregious backdating practices at numerous companies. This article expanded upon  
16 recent academic work by Professors Lie and Heron suggesting that backdating was widespread and  
17 just another way some executives enriched themselves at shareholders' expense. The *Journal*  
18 analysis also bolstered recent academic work by revealing that stock option backdating is a broad  
19 problem and identified "wildly improbable option-grant patterns" at numerous companies.

20           63.     Following *The Wall Street Journal* article, at least two other respected institutions  
21 issued similar analyses of various companies' stock option granting policies. On May 22, 2006, one  
22 of the largest and most sophisticated investment banks in the world, Merrill Lynch, published a study  
23 entitled "Options Pricing – Hindsight is 20/20," which also analyzed the stock option granting  
24 patterns at various companies in order to detect backdating. CFRA similarly studied the likelihood  
25 that backdating was occurring at certain companies in an article entitled "Options Backdating –  
26

1 Which Companies are at Risk?” CFRA determined that F5 was among those companies with the  
2 “highest risk of options backdating” between 1997 and 2002.

3 64. Each of these institutional studies analyzed similar information in order to determine  
4 the likelihood that backdating occurred at a given company, *i.e.*, they identified stock option grants  
5 and analyzed the returns surrounding the purported grant dates. According to *The Wall Street*  
6 *Journal*, academics who have studied backdating have noted that “a pattern of sharp stock  
7 appreciation after grant dates is an indication of backdating; by chance alone, grants ought to be  
8 followed by a mixed bag of stock performance – some rises, some declines.” The Merrill Lynch  
9 report concurs noting that “companies should not be generating any systematic excess return in  
10 comparison to other investors as a result of how options pricing events are timed.”

11 65. The Merrill Lynch report examined the “20 day period subsequent to options pricing  
12 in comparison to stock price returns for the calendar year in which the options were granted.”  
13 According to Merrill Lynch, the 20-day analysis makes sense because, “[t]heoretically, if the timing  
14 of options grants is an arm’s length process, and companies haven’t systematically taken advantage  
15 of their ability to backdate options within the 20-day windows that the law provided prior to the  
16 implementation of Sarbanes Oxley in 2002, there shouldn’t be any difference between the two  
17 measures.” Moreover, the Merrill Lynch report acknowledged this 20-day analysis is “the easiest  
18 and simplest way” to measure how aggressive the pricing of options has been.<sup>2</sup>

19 66. As in the Merrill Lynch report, *The Wall Street Journal* article reviewed the 20-day  
20 returns surrounding each option grant and ranked them among all possible 20-day returns. The  
21 *Journal*’s methodology conforms to academic theories stating that “the most effective way to  
22 consistently capture low-price days for option grants is to wait until after a stock has risen, then  
23 backdate a grant to a day prior to that rise.” The article explained that “[b]ecause nobody actually

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24  
25 <sup>2</sup> Several Delaware Chancery Court decisions acknowledge the usefulness of the Merrill Lynch analysis in  
26 determining whether a pattern of backdating exists. *See, e.g., Ryan v. Gifford*, 918 A.2d 341, 354-55 (Del. Ch. 2007);  
*Conrad v. Blank*, No. 2611-VCL, slip. op. at 21 n.30 (Del. Ch. Sept. 7, 2007) (“*Staples*”).



1 authorizing the grant on a given day could have known how the stock would do in the future, the  
2 *Journal's* analysis used post-grant price surges as an indication of possible backdating." New York  
3 University finance professor David Yermick and University of Iowa finance professor Erik Lie said  
4 that 20-day post-grant price surges are "a reasonable yardstick to detect possible backdating" and  
5 that "[u]sing a longer period, such as a year, wouldn't be a good way to spot backdating of a few  
6 days or weeks because the longer-term trading would overwhelm any backdating effect."<sup>3</sup>

7         67. Although *The Wall Street Journal* article, CFRA, and Merrill Lynch reports vary  
8 slightly in their methodologies, plaintiffs analyze defendants' grants here under the Merrill Lynch  
9 methodology because, among other things, courts in Delaware and California have viewed the  
10 Merrill Lynch analysis favorably. *Staples*, No. 2611-VCL, slip. op. at 21 n.30; *Ryan*, 918 A.2d at  
11 355 n.34 (the Merrill Lynch report "emphatically suggests that either defendant directors knowingly  
12 manipulated the dates on which options were granted, or their timing was extraordinarily lucky"); *In*  
13 *re Computer Scis. Corp. Derivative Litig.*, No. CV 06-05288 MRP (Ex), 2007 U.S. Dist. LEXIS  
14 25414, at \*44-\*45 (C.D. Cal. Mar. 27, 2007) (noting that the "'empirical evidence' in the form of an  
15 investment bank's [Merrill Lynch's] statistical analysis . . . suggested backdating of the option  
16 grants").

17         68. Plaintiffs studied the 20-day returns following each of F5's 26 stock option grants to  
18 officers and directors between 1998 and 2006. Overall, plaintiffs' analysis revealed that, on average,  
19 between 1999 and 2006, defendants received a 788.6% return on their backdated stock option grants  
20 while shareholders received, on average, only a 19.9% return over the same time period – a disparity  
21 of 768.7% in favor of management. Analysis of the returns for each of the 26 stock option grants  
22

---

23 <sup>3</sup> CFRA's analysis is similar to the Merrill Lynch and *The Wall Street Journal* analyses but looks at a 40-day  
24 window rather than 20 days. "CFRA considers a company's options backdating risk to be significant when a company  
25 has, on three or more occasions, granted options to executives at exercise prices and dates that matched exactly or were  
26 close to a 40-day low in the company's stock price." Here, a member of option grants to F5 officers and directors appear  
to test positive for backdating, *i.e.*, October 1, 1999, February 10, 2000, July 24, 2000, January 1, 2001, April 20, 2001,  
April 27, 2001, May 6, 2002, May 8, 2003, and April 30, 2004.

identified in the Complaint with the Merrill Lynch methodology supports an inference that several grants appear to be backdated, *i.e.*, October 1, 1999, February 10, 2000, July 24, 2000, January 1, 2001, April 20, 2001, April 27, 2001, May 6, 2002, May 8, 2003, and April 30, 2004. The following chart details the differences between management and shareholder returns:

Grant	20 Trading Day Return	Annualized Management Return	Annualized Shareholder Return	Difference in Returns
October 1, 1999	103.9%	1869.4%	-50%	1919.4%
February 10, 2000	29.3%	527%	-50%	577%
July 24, 2000	26.3%	473%	-50%	523%
January 1, 2001	64.5%	1160.5%	-69.3%	1229.8%
April 20, 2001	37.8%	680%	-69.3%	749.3%
April 27, 2001	90.1%	1622.6%	-69.3%	1691.9%
May 6, 2002	7.3%	131.1%	4%	127.1%
May 8, 2003	18.7%	337.2%	142%	195.2%
April 30, 2004	16.4%	295%	54.1%	240.9%

Indeed for several years management consistently enjoyed far greater returns on their stock option grants than did ordinary shareholders. Although the grants were made to F5 executives at different times during the year, those grants consistently received returns between 127% and 1900% greater than shareholders.

69. Another indicia of backdating is a long period of time between the purported grant date and the date the grant was disclosed to the SEC. Thus, plaintiffs also reviewed the amount of time between the purported stock option grant date and disclosure of the grants to the SEC via Forms 3, 4 or 5. Grants that are not disclosed to the SEC in a timely fashion are more likely backdated. "If executives are backdating, a longer reporting lag implies that, on average, they were backdating aggressively, seeking a lower exercise price. This in turn implies that the extent of stock price rise following the manager-designated grant date will be positively correlated with the reporting lag." M. P. Narayanan, Cindy A. Schipani & H. Nejat Seyhun, *The Economic Impact of Backdating of Executive Stock Options*, 105 Mich. L. Rev. 1597, 1603 (2007). For the stock option grants plaintiffs allege were backdated after SOX was implemented, plaintiffs reviewed the price

1 movement in the lag time between the grant date and the date defendants disclosed the grant to the  
2 SEC.<sup>4</sup>

3 70. Similarly, stock option grants are more likely backdated when they are discretionary  
4 and granted by a sporadic method.<sup>5</sup> Accordingly, plaintiffs also reviewed each grant to determine  
5 whether or not it was granted in a sporadic fashion or on a fixed date pursuant to a non-discretionary  
6 stock option plan.

### 7 **Backdated Stock Option Grants at F5**

8 71. Between 1999 and March 2006, the Company publicly disclosed 26 stock option  
9 grants.<sup>6</sup> Out of the 26 total grants, 9 were granted with an exercise price equal to the lowest closing  
10 price for F5 stock during that month. Moreover, 3 of the 26 grants were issued with an exercise  
11 price equal to the second lowest closing price for F5 stock that month. Thus, 12 of the 26 grants  
12 issued to F5 insiders were granted at either the lowest or second lowest closing price for F5 common  
13 stock during the months of the grant. The chart below illustrates the relative ranks of each of F5's  
14 26 stock option grants:

<b>Purported Grant</b>	<b>Monthly Rank</b>	<b>Quarterly Rank</b>
October 1, 1999	2	2
October 20, 1999	12	12
December 30, 1999	8	27
February 10, 2000	1	9
February 17, 2000	20	47

21 <sup>4</sup> "It has been documented that the Sarbanes-Oxley Act of 2002 (SOX) has not been successful in fully  
eliminating clandestine backdating or other forms of manipulation such as springloading." *Id.* at 1601.

22 <sup>5</sup> That a stock option grant might be issued pursuant to a non-discretionary fixed date plan only reduces, but does  
23 not eliminate, the likelihood that stock options were being backdated. For example, in a recent stock option backdating  
24 action against CNET Networks, Inc., the company was forced to re-price so-called non-discretionary fixed date grants  
and admit that those grants were not actually granted on the fixed-date required by the applicable stock option plan. *See*  
CNET Networks, Inc.'s January 29, 2007 Form 10-K/A at 98-99.

25 <sup>6</sup> The 26 grants at issue in this Complaint were publicly disclosed by F5 but do not include 3 grants made prior to  
26 F5's Initial Public Offering.

1	March 31, 2000	1	1
2	April 13, 2000	9	53
3	June 30, 2000	22	51
4	July 24, 2000	1	12
5	September 29, 2000	1	1
6	October 23, 2000	21	51
7	January 1, 2001	1	1
8	March 16, 2001	1	1
9	April 20, 2001	19	20
10	April 27, 2001	13	13
11	May 6, 2002	1	11
12	February 13, 2002	1	18
13	May 8, 2003	2	23
14	October 20, 2003	12	31
15	April 29, 2004	2	32
16	April 30, 2004	1	10
17	February 24, 2005	16	44
18	August 1, 2005	23	30
19	September 30, 2005	9	39
20	November 1, 2005	8	50
21	March 2, 2006	3	24

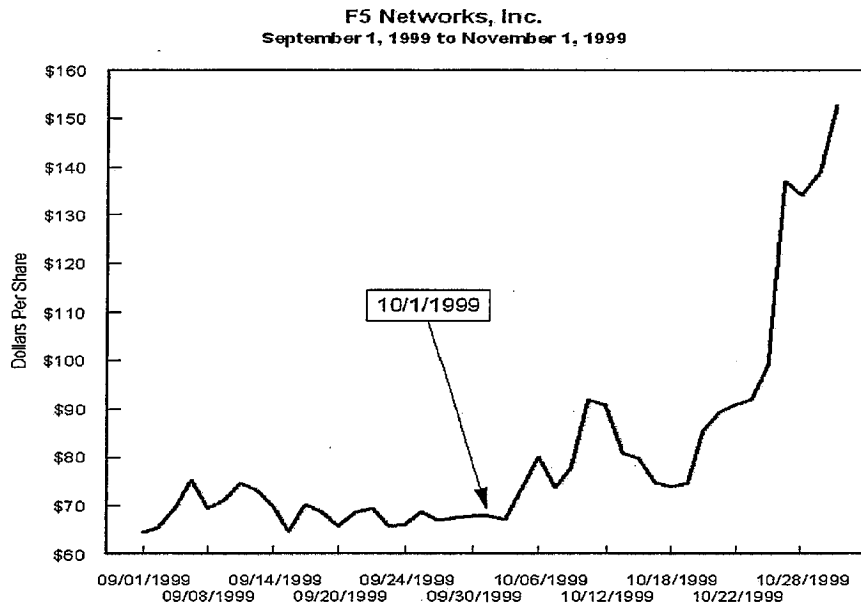
72. According to the analysis conducted by plaintiffs' expert, RGL Forensic Accountants and Consultants ("RGL"), the odds that 9 grants fall on the date with the lowest closing price and that 3 grants fall on the date with the second lowest closing price (out of 20 possible trading days) is 1 in 2,764,905. The odds that 9 grants fall on the date with the lowest closing price alone (out of 20 possible trading days) is 1 in 391,905.

73. Plaintiffs examine F5's stock option grants in greater detail below. In assessing whether a pattern of backdating exists, and if it has been pleaded with sufficient particularity, the Delaware courts have looked to a variety of facts. As Chancellor Chandler articulated in his seminal decision on backdating in *Ryan*, a pattern of backdating is alleged with sufficient particularity when the dates, prices, recipients and the plan language violated are identified. *Ryan*, 918 A.2d at 355.

1 The Delaware courts have rejected attempts by other courts to engage in mini-trials at the pleading  
2 stage under the guise that Delaware law requires such proceedings. *Staples*, No. 2611-VCL, slip op.  
3 at 17 n.22.

#### 4 **October 1, 1999 Stock Option Grant**

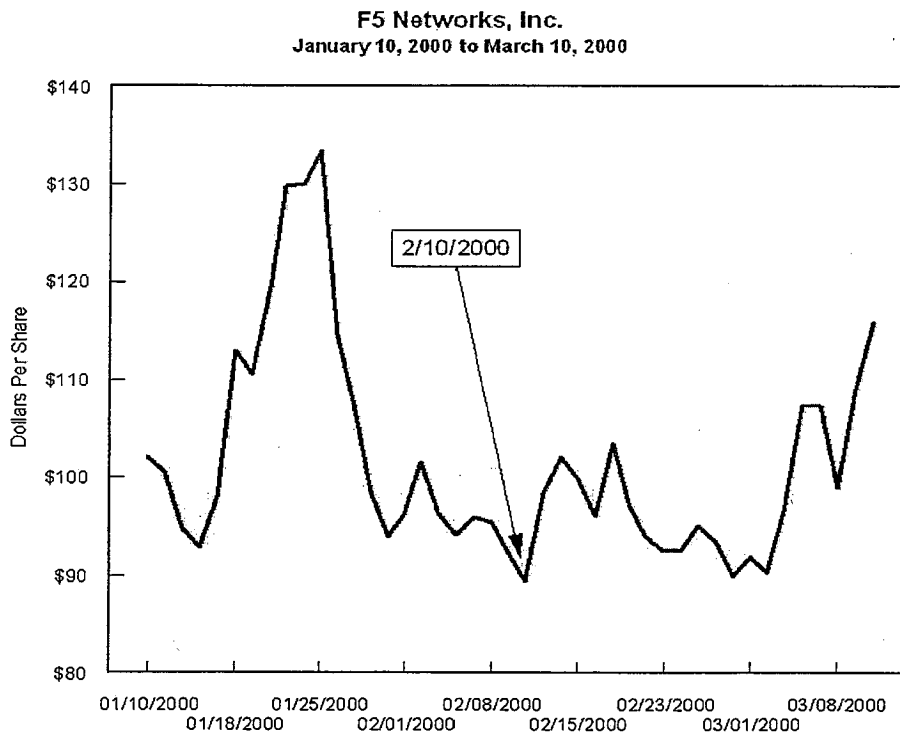
5 74. A total of 37,500 options worth \$2,552,250 were purportedly granted on October 1,  
6 1999, to F5's then Director and Chief Technical Officer, Amdahl by defendants Higginson, Guelich  
7 and Grinstein. The exercise price for this purported grant was \$68.06, which matched the closing  
8 stock price on that date. The exercise price was the **second lowest** closing price for the stock for the  
9 month of October 1999. The price of the stock 20 trading days after the grant was \$138.75 per  
10 share, for a 20-day cumulative return based on the exercise price of 103.9%. On an annual basis,  
11 Amdahl received at **1869.4%** return compared to shareholders who only received a -50% return. A  
12 graph demonstrating the suspicious timing of this grant just before a sharp increase in the price of F5  
13 stock appears below:



75. This grant was not disclosed to shareholders for 70 days, when defendant Amdahl filed a Form 4 with the SEC on December 6, 1999. During that time, the market price for F5 stock increased to \$116.00 per share or 99.1%. If this option grant was backdated by 20 days it would have been in-the-money to the tune of \$2,650,875.

#### February 10, 2000 Stock Option Grant

76. A total of 112,500 options worth \$10,068,750 were purportedly granted on February 10, 2000, to F5's then Director and Chief Technical Officer, Amdahl by defendants Higginson, Guelich and Grinstein. The exercise price for this purported grant was \$89.50, which matched the closing stock price for that date. The exercise price was the *lowest* closing price for the stock for the month of February 2000. The price of the stock 20 trading days after the grant was \$115.75 per share, for a 20-day cumulative return based on the exercise price of 29.3%. The annualized 20-day return for this grant is 527% compared to shareholders who received a -50% return. A graph illustrating the stock price 20 days following the grant appears below:



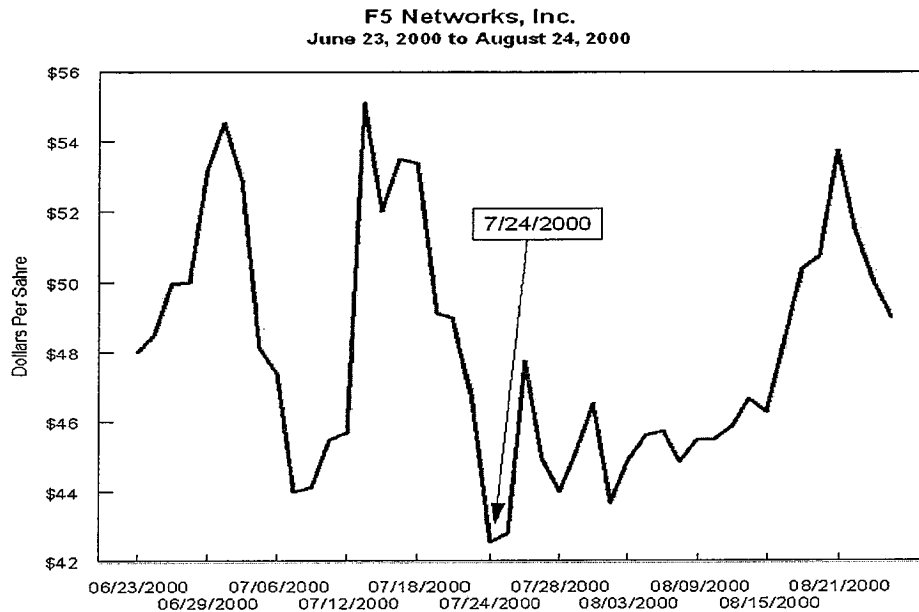
1           77.     This grant was not disclosed to shareholders for 32 days, when defendant Amdahl  
2 filed a Form 4 with the SEC on March 13, 2000. During that time, the market price for F5 stock  
3 increased to \$109.69 per share or 22.6%. If this option grant was backdated by 20 days, it would  
4 have been in-the-money to the tune of \$2,953,125.

5 **July 24, 2000 Stock Option Grant**

6           78.     A total of 645,000 options worth \$27,451,200 were purportedly granted on July 24,  
7 2000, to F5's CEO, McAdam. The exercise price was \$42.56 per share, which matched the closing  
8 price for F5 stock on that date. This exercise price was the lowest closing price for the month of July  
9 2000. McAdam purportedly received these stock options pursuant to a Non-Qualified Stock Option  
10 Agreement. This agreement does not contain a date on which it was signed. Instead, the agreement  
11 says it was entered into "as of July 24, 2000." Defendants did not disclose this grant until August 2,  
12 2000 when McAdam filed a Form 3 with the SEC. The price of F5's stock on August 2, 2000 was  
13 \$43.69, or \$1.13 per share higher than on the purported grant date. Had this grant been backdated by  
14 nine days it would have been in-the-money to the tune of \$728,850. The price of the stock 20  
15 trading days after the grant was \$53.75 per share, for a 20-day cumulative return based on the  
16 exercise price of 26.3% or 473.3% on an annual basis.

17           79.     Defendants purport to have also granted 50,000 options with an exercise price of \$1  
18 per share to McAdam on July 24, 2000. This grant also appears to be pursuant to a Non-Qualified  
19 Stock Option Agreement that does not contain a date on which it was signed. Just as before, this  
20 agreement only says it was entered into "as of July 24, 2000." The closing price for that date was  
21 \$42.56 per share, which was the lowest closing price for the month of July 2000. However, instead  
22 of reporting this grant on August 2, 2000, along with the other 645,000 shares purportedly granted to  
23 him on July 24, 2000, defendant McAdam waited for 72 days (or 2-1/2 months) to disclose this grant  
24 via a Form 4 filed with the SEC on October 4, 2000. This delay alone is an indication of backdating.  
25 But the fact that defendants split the reporting of two grants that were purportedly granted to  
26 McAdam on the same day provides an even stronger inference that these option grants were

1 backdated. On October 4, 2000, the market price for F5 stock was \$33.19 per share. Thus, this  
2 purported 50,000 share grant was in-the-money to the tune of \$1,659,500.<sup>7</sup> A graph illustrating the  
3 20 days following the grant appears below:



15

16 **January 1, 2001 Stock Option Grant**

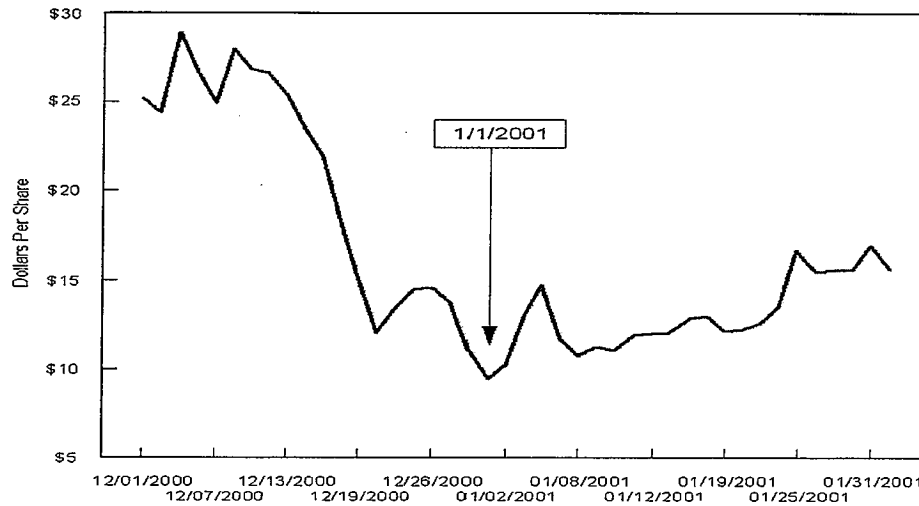
17 80. A total of 387,500 options worth \$3,681,250 were purportedly granted on January 1,  
18 2001, to eight F5 executives (five officers, including F5's CEO, McAdam, and three Directors) by  
19 defendants Higginson, Guelich and Grinstein. The exercise price for this purported grant was \$9.50,  
20 which matched the closing stock price on that date. The exercise price was the *lowest* closing price  
21 for the stock for the month of January 2001. The price of the stock 20 trading days after the grant  
22 was \$15.62 per share, for a 20-day cumulative return based on the exercise price of 64.5%. The 20-  
23 day returns, on an annual basis, were 1160.5% versus shareholders who received a -69.3% return  
24 that year. A graph illustrating the stock price 20 days following the grant appears below:

25

26 <sup>7</sup> If this option grant was backdated by 20 days, it would have been in-the-money to the tune of \$2,637,500.



**F5 Networks, Inc.**  
December 1, 2000 to February 1, 2001

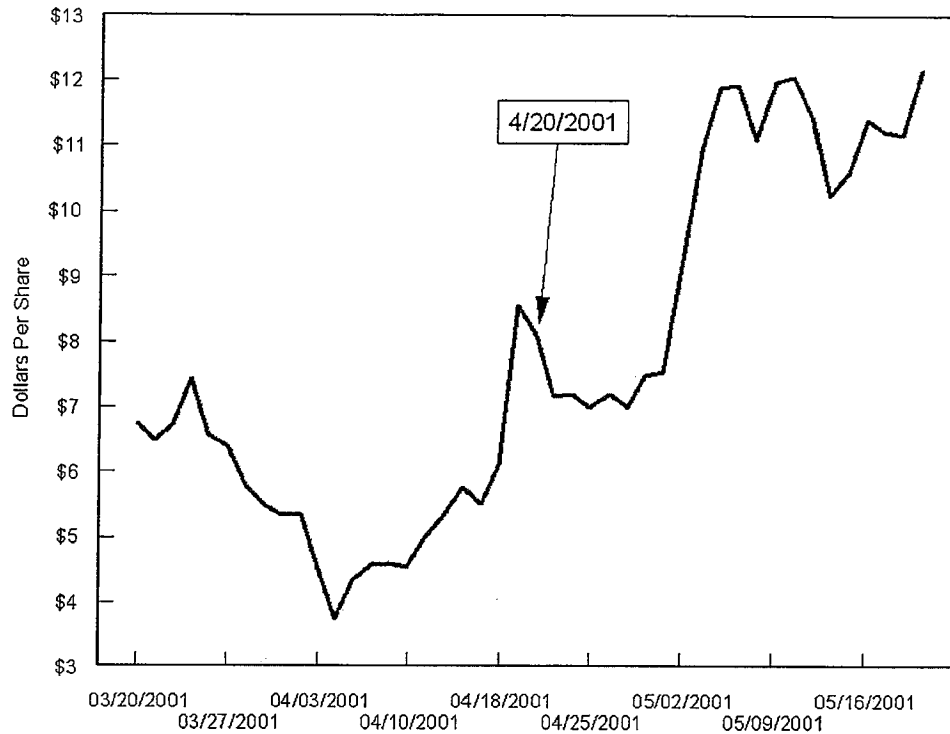


81. This grant to executives was not disclosed to shareholders for 37 days, when McAdam, Goldman, Helsel, Pancottine and Eames filed Forms 4 with the SEC on February 8, 2001. During that time, the market price for F5 stock increased to \$12.81 per share or 34.8%. If this option grant was backdated by 20 days, it would have been in-the-money to the tune of \$2,371,500. According to the 2002 Proxy Statement, the grants to directors Higginson, Guelich and Grinstein were made pursuant to the 1998 Plan.

#### **April 20, 2001 Stock Option Grant**

82. A total of 45,000 options worth \$364,500 were purportedly granted on April 20, 2001, to three F5 Directors, Higginson, Guelich and Grinstein. The exercise price for this purported grant was \$8.10, which matched the closing price of F5's stock on that date. This exercise price was one of the highest closing prices for F5 stock in the month of April 2001 but the price of F5 stock rose by 37.8% to \$11.16 per share within 20 trading days of the grant. The 20-day returns for this grant, on an annual basis, were 680% compared to shareholders who lost money with a -69.3% return that year. A graph demonstrating the timing of this grant appears below:

**F5 Networks, Inc.**  
March 20, 2001 to May 21, 2001

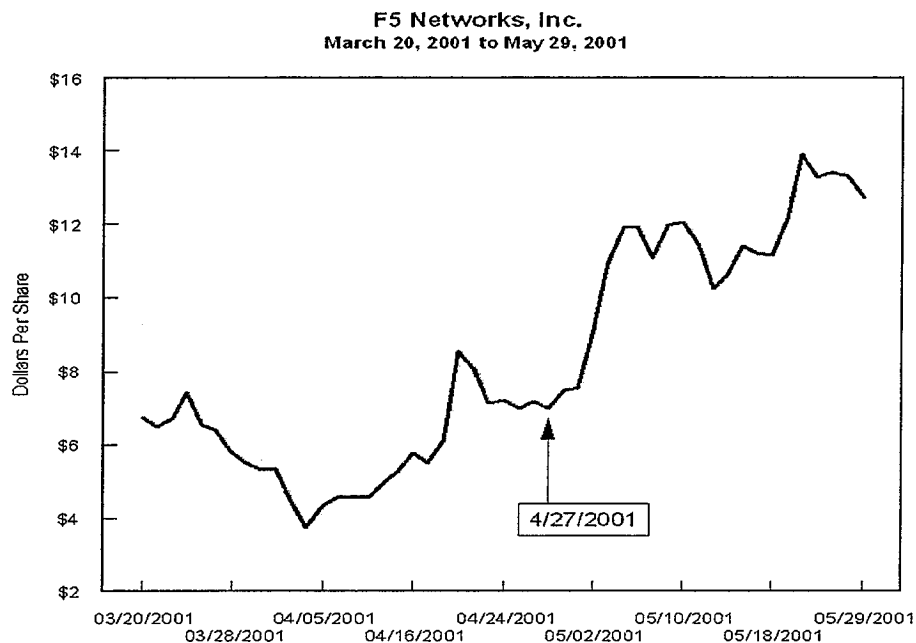


83. This grant was not disclosed to shareholders for 18 days, when Guelich and Higginson filed Forms 4 with the SEC on May 8, 2001. During that time, the market price for F5 stock increased to \$11.10 per share, or 37%. If this option grant was backdated by 18 days, it would have been in-the-money to the tune of \$135,000. According to F5's 2002 Proxy Statement these grants were issued under the 1998 Plan.

**April 27, 2001 Stock Option Grant**

84. A total of 475,000 options worth \$3,325,000 were purportedly granted on April 27, 2001, to six executives, including F5's CEO, McAdam by defendants Higginson, Guelich and Grinstein. The exercise price for this purported grant was \$7.00, which matched the closing price of F5's stock on that date. The exercise price was the 13th lowest price for the month of April 2001 and for the fiscal quarter. The price of the stock 20 trading days after the grant was \$13.31 per share,

1 for a 20-day cumulative return based on the exercise price of 90.1% or 1622.6% on an annual basis.  
2 Shareholders, however, actually lost money and suffered a -69.3% return that year. A graph  
3 illustrating the 20 days following the grant appears below:

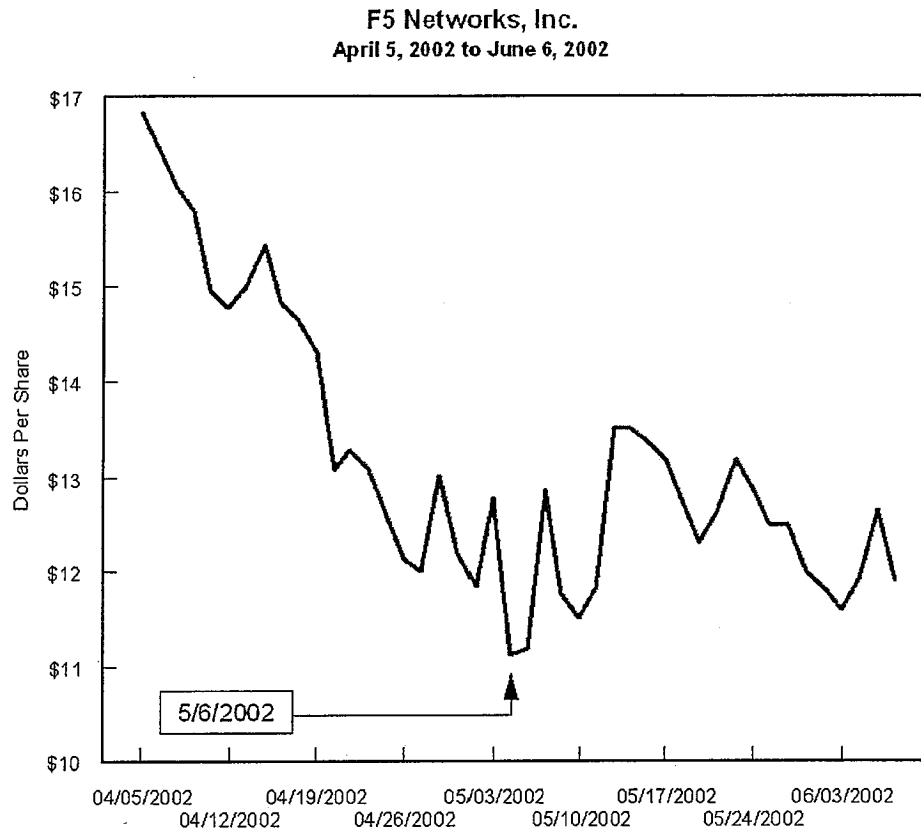


16 85. Defendants waited 11 days to disclose this grant. Pancottine filed a Form 4 with the  
17 SEC on May 8, 2001. During that time, the market price for F5 stock increased to \$11.10 per share  
18 or 56%. If this option grant was backdated by 11 days, it would have been in-the-money to the tune  
19 of \$1,947,500.

#### 20 May 6, 2002 Stock Option Grant

21 86. A total of 572,916 options worth \$6,370,825 were purportedly granted on May 6,  
22 2002, to nine F5 executives (six officers, including F5's CEO, McAdam, and three Directors). The  
23 exercise price for this purported grant was \$11.12, which matched the closing price of F5's stock on  
24 that date. This exercise price was the **lowest** price for the month of May 2002. The price of the  
25 stock 20 trading days after the grant was \$11.93 per share, for a 20-day cumulative return based on  
26 the exercise price of 7.3%. The annualized 20-day returns for this grant were 131.1% compared to

1 shareholders who only received a 4% return that year. A graph illustrating the stock price 20 days  
2 following the grant appears below:

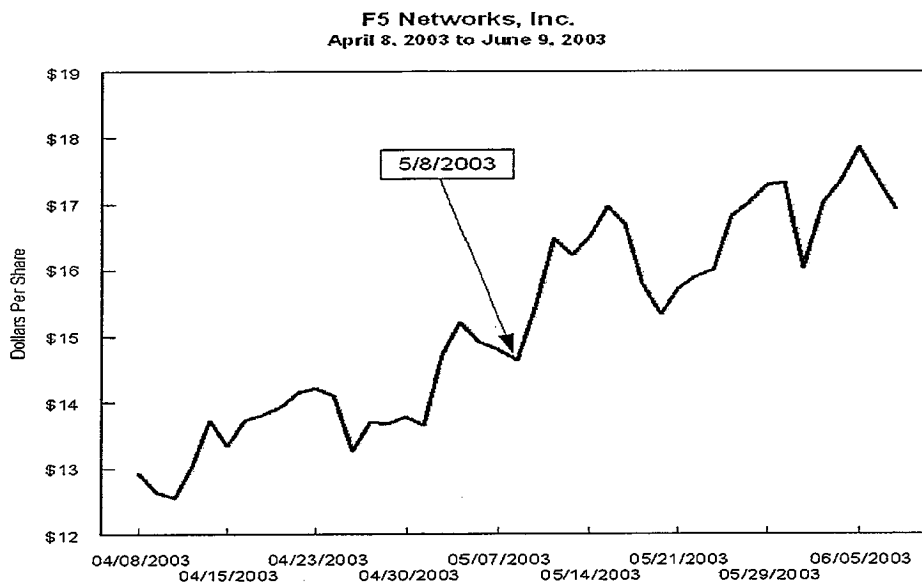


18 87. This grant was not disclosed to shareholders for 32 days, when Pancottine filed a  
19 Form 4 with the SEC on June 7, 2002. During that time, the market price for F5 stock increased to  
20 \$12.16 per share or 9.4%. If this option grant was backdated by 20 days, it would have been in-the-  
21 money to the tune of \$464,061. According to the 2003 Proxy, the grants to Higginson, Guelich, and  
22 Grinstein were granted pursuant to the 1998 Plan.

### 23 **May 8, 2003 Stock Option Grant**

24 88. A total of 435,000 options worth \$6,368,400 were purportedly granted on May 8,  
25 2003, to six F5 executives, including F5's CEO, McAdam by defendants Higginson, Guelich and  
26 Grinstein. The exercise price for this purported grant was \$14.64, which matched the closing price

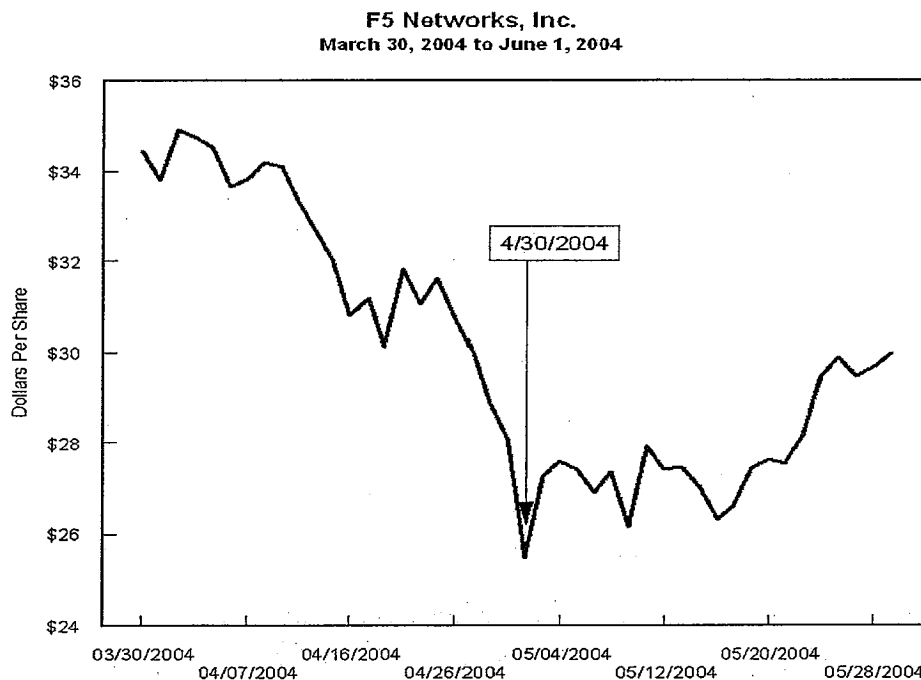
1 of F5's stock on that date. The exercise price was the *second lowest* price for the month of May  
2 2003. The price of the stock 20 trading days after the grant was \$17.38 per share, for a 20-day  
3 cumulative return based on the exercise price of 18.7% or 337.2% on an annual basis. Shareholders  
4 received a 142% return that year. A graph illustrating the stock price 20 days following the grant  
5 appears below:



17 90. This grant was not disclosed to shareholders for five days, when Pancottine filed a  
18 Form 4 with the SEC on May 13, 2003. During that time, the market price for F5 stock increased to  
19 \$16.23 per share or 10.9%. If this option grant was backdated by five days, it would have been in-  
20 the-money to the tune of \$691,650.

1 **April 30, 2004 Stock Option Grant**

2 91. A total of 300,000 options worth \$7,647,000 were purportedly granted on April 30,  
3 2004, to six F5 executives, including F5's CEO, McAdam by defendants Higginson, Guelich and  
4 Malone. The exercise price for this purported grant was \$25.49, which matched the closing price of  
5 F5's stock on that date. The exercise price was the *lowest* closing price for the month of April 2004.  
6 Twenty trading days after the grant the stock closed at \$29.68 per share, for a 20-day cumulative  
7 return based on the exercise price of 16.4%. The 20-day return, on an annualized basis, for this grant  
8 was 295% compared to shareholders who earned a 54.1% return that year. A graph illustrating the  
9 stock price 20 days following the grant appears below:



23 92. Defendants waited 21 days to disclose this grant via a Form 4 filed with the SEC by  
24 Coburn on May 21, 2004. During that time, the market price for F5 stock increased to \$27.57 per  
25 share or 8.2%. If this option grant was backdated by 20 days, it would have been in-the-money to  
26 the tune of \$1,257,000.

1           93. Overall, between 1999 and March 2006, there were several backdated option grants at  
2 F5. Backdated, in-the-money, options were granted during that period to F5 top executives and  
3 members of the Board of Directors, including Compensation Committee members. Almost all of  
4 these grants made by and/or to defendants during the relevant period were granted at or near the  
5 lowest price for the month or fiscal quarter and every one of these grants demonstrated abnormal 20-  
6 day returns. Because the statistical odds of such an occurrence happening randomly are remote, the  
7 only likely explanation for this pattern was that their stock options had been backdated. This  
8 explanation is consistent with F5's November 8, 2006 admission that the recorded grant dates for  
9 certain stock option grants during fiscal 1999-2004 should not be relied upon as the measurement  
10 date for accounting purposes.

11           94. Backdating the date of issuance of the executive stock options violated F5's stock  
12 option plans and directly contradicted the public disclosures in F5's proxy statements and SEC  
13 reports which defendants caused to publish at various times during fiscal 1999-2006. The secret  
14 practice of backdating stock option grants to themselves and their colleagues was a complete breach  
15 of defendants' fiduciary duties, including their duties of good faith, honesty and loyalty, owed to F5  
16 and its shareholders.

17           95. The backdating scheme, among other things, enabled defendants to disguise the fact  
18 that the Company was paying higher compensation to executives and employees by awarding them  
19 in-the-money options and avoiding having to expense the in-the-money portion as compensation  
20 expense thus avoiding reductions in the Company's net income or increases in its net losses.  
21 Keeping the scheme secret also hid the injury to the Company which occurred, in part, when  
22 executives and employees exercised the options and made capital contributions to F5 that were less  
23 than they should have been, had the options not been granted in-the-money.

24           96. The secret backdating scheme also conferred great personal financial benefits on  
25 defendants. Specifically, from at least 1999 through March 2006, defendant McAdam received at  
26 least 880,000 backdated options; defendant Amdahl received at least 150,000 backdated options;

1 defendant Eames received at least 260,000 backdated options; defendant Goldman received at least  
2 215,000 backdated options; defendant Helsel received at least 80,000 backdated options; defendant  
3 Hussey received at least 70,000 backdated options; defendant Pancottine received at least 265,000  
4 backdated options; defendant Higginson received at least 37,500 backdated options; defendant  
5 Guelich received at least 37,500 backdated options; defendant Grinstein received at least 37,500  
6 backdated options; defendant Coburn received at least 165,000 backdated options; defendant Reiter  
7 received at least 177,916 backdated options; and defendant Hull received at least 40,000 backdated  
8 options. All of these stock options were backdated and carried an exercise price below fair market  
9 value at the time of grant. Defendants have made millions of dollars on the exercise of these options  
10 and sales of the underlying shares, and collectively continue to hold backdated options worth  
11 millions of dollars.

#### 12 **F5's False and Misleading Proxy Statements**

13 97. Between 1999 and 2006, defendants caused F5 to send shareholders proxy statements  
14 in connection with the Company's annual shareholder meetings. Each proxy statement was  
15 submitted to shareholders by the entire Board of Directors. The entire Board urged shareholder  
16 approval of proposals that stated that the Board granted stock options at fair market value using  
17 language like: "THE BOARD RECOMMENDS A VOTE 'FOR' APPROVAL OF THIS  
18 PROPOSAL." 2001 Proxy at 10; 2003 Proxy at 22; 2004 Proxy at 21.

19 98. Defendants approved each of these proxy statements before the statements were  
20 disseminated to shareholders and filed with the SEC. Defendants therefore knew, or were reckless in  
21 not knowing, that the proxy statements were materially false and misleading when issued.

22 99. The F5 proxy statements that were sent to shareholders by defendants annually in  
23 connection with annual shareholders' meetings typically concerned the election of directors, the  
24 approval and adoption of F5's stock option plans and authorization to reserve shares for future  
25 issuance under the stock option plans. At the time each proxy statement was sent to shareholders  
26



1 between 2000 and 2006, each proxy statement contained materially false and misleading disclosures  
2 or omitted information about F5's stock option practices, as detailed below.

3 **F5's 2000 Proxy Statement**

4 100. On or about January 18, 2000, F5 filed a Form 14A proxy statement with the SEC. In  
5 the proxy statement, the F5 Board of Directors, consisting of defendants Amdahl, Higginson,  
6 Guelich, Grinstein and Hussey, made the following representations about F5's stock option plans  
7 and granting practices:

8 Directors currently receive no cash compensation from the Company for their  
9 services as members of the Board of Directors. . . . Eligible non-employee directors  
10 receive automatic option grants under the Company's 1999 Non-Employee  
11 Directors' Option Plan *with an exercise price equal to the fair market value of the  
Common Stock on the date of grant.*

12 101. This statement was false and misleading because defendants, including Guelich and  
13 Higginson who sat on the Compensation Committee and made recommendations regarding stock  
14 options to the entire Board, approved stock option grants with an exercise price less than fair market  
15 value on the actual date the grant was made.

16 102. Further, F5's Board of Directors, by and through its Compensation Committee  
17 (Guelich and Higginson), made the following representations about the purposes of F5's stock  
18 option plans:

19 The compensation committee believes that employee equity ownership  
20 provides significant motivation to executive officers to maximize value for the  
21 Company's shareholders and, therefore, periodically grants stock options under our  
22 employee stock option plans. *Stock options are typically granted at the current  
market price and will only have value if the Company's stock price increases over  
the exercise price.*

23 The compensation committee determines the size and frequency of option  
24 grants for executive officers, based on recommendations from the Chief Executive  
25 Officer. Recommendations for options are based on the relative position and  
26 responsibilities of each executive officer, previous and expected contributions of  
each officer to the Company's, and previous options grants to such executive  
officers.

1 103. The F5 Board of Directors also presented amendments to the 1998 Plan for  
2 shareholder approval. In connection with the amendments, the Board made the following  
3 representations about the administration of the 1998 Plan:

4 At the Annual Meeting, the shareholders of the Company will be asked to  
5 approve an amendment to the 1998 Equity Incentive Plan (the "1998 Plan") which, if  
6 approved, will increase the number of shares of Common Stock available for  
purchase under the 1998 Plan by 1,000,000 shares, to an aggregate of 3,300,000  
shares. . . .

7 The Board of Directors believes that the 1998 Plan has contributed to  
8 strengthening the incentive of participating employees to achieve the objectives of  
the Company and its shareholders by encouraging employees to acquire a greater  
9 proprietary interest in the Company. The Board of Directors believes that additional  
shares must be reserved for use under the 1998 Plan to enable the Company to attract  
and retain key employees through the granting of options under the 1998 Plan.

10 \* \* \*

11 Options granted under the 1998 Plan may be ISOs or NSOs. . . . The Board of  
12 Directors determines the exercise price of options granted under the 1998 Plan.  
13 *However, in the case of an ISO, the exercise price cannot be less than 100% of the*  
14 *fair market value of the Company's Common Stock on the date of grant and, in the*  
*case of an NSO, the exercise price cannot be less than 50% of the fair market*  
*value of the Company's Common Stock on the date of the grant. . . .*

15 \* \* \*

16 No person may be granted options under the 1998 Plan covering an aggregate  
17 of more than 200,000 shares of Common Stock in any calendar year.

18 \* \* \*

19 THE BOARD RECOMMENDS A VOTE "FOR" APPROVAL OF THIS  
PROPOSAL.

20 104. Each of the above statements concerning F5's stock option plans and the value of the  
21 stock options on the date of grant were false and misleading. This is because F5, in fact, backdated  
22 option grants to defendants Amdahl and McAdam, which was not permitted by F5's stock option  
23 plans. Moreover, the NSOs granted to directors under the 1998 Plan were all disclosed in proxy  
24 statements as having been granted at 100% of fair market value and not at discounted prices. *See*  
25 *2001 Proxy at 4; 2002 Proxy at 2; 2004 Proxy at 5.* Contrary to the above representations, none of  
26

1 the options backdating acknowledged by F5 in November 2006 was ever approved by the  
2 shareholders, nor were shareholders ever aware of this illicit compensation.

3 **F5's 2001 Proxy Statement**

4 105. On or about March 20, 2001, F5 filed a Form 14A proxy statement with the SEC. In  
5 the proxy statement, the F5 Board of Directors, consisting of defendants McAdam, Higginson,  
6 Guelich, Grinstein, Amdahl and Hussey, made the following representations about F5's stock option  
7 plans and granting practices:

8 Directors currently receive no cash compensation from the Company for their  
9 services as members of the Board of Directors. . . . During fiscal 2000, eligible non-  
10 employee directors received automatic option grants under the Company's 1999  
Non-Employee Directors' Option Plan *with an exercise price equal to the fair  
market value of the Common Stock on the date of grant.* . . .

11 Beginning in 2001, non-employee directors will receive 15,000 options to  
12 purchase Common Stock upon their initial appointment to the Board. . . . In addition,  
13 all non-employee directors who serve on a board committee and who have been on  
14 the board for at least six months will receive 7,500 options in January and 7,500  
options the following June of each year. *These options* will be fully vested upon  
grant, and *will have an exercise price equal to the closing price of the Company  
stock on the grant date.*

15 106. Further, the F5 Board of Directors presented amendments to the 1998 Plan for  
16 shareholder approval. In connection with the amendments, the Board made the following  
17 representations about F5's stock option plans and granting practices:

18 At the Annual Meeting, the shareholders of the Company will be asked to approve an  
19 amendment to the 1998 Equity Incentive Plan (the "1998 Plan") which, if approved,  
will increase the number of shares of Common Stock available for purchase under  
20 the 1998 Plan by 2,000,000 shares, to an aggregate of 5,300,000 shares. . . .

21 The Board of Directors believes that the 1998 Plan has contributed to  
strengthening the incentive of participating employees to achieve the objectives of  
22 the Company and its shareholders by encouraging employees to acquire a greater  
proprietary interest in the Company. The Board of Directors believes that additional  
23 shares must be reserved for use under the 1998 Plan to enable the Company to attract  
and retain key employees through the granting of options under the 1998 Plan.

24 \* \* \*

25 Options granted under the 1998 Plan may be ISOs or NSOs. . . . The Board of  
Directors determines the exercise price of options granted under the 1998 Plan.  
26 *However, in the case of an ISO, the exercise price cannot be less than 100% of the  
fair market value of the Company's Common Stock on the date of grant and, in the*

1 *case of an NSO, the exercise price cannot be less than 50% of the fair market*  
2 *value of the Company's Common Stock on the date of the grant. . . .*

3 \* \* \*

4 No person may be granted options under the 1998 Plan covering an aggregate  
5 of more than 200,000 shares of Common Stock in any calendar year.

6 \* \* \*

7 THE BOARD RECOMMENDS A VOTE "FOR" APPROVAL OF THIS  
8 PROPOSAL.

9 107. Each of the above statements concerning F5's stock option plans and the value of  
10 stock options on the date of grant was false and misleading. This is because F5, in fact, backdated  
11 option grants to defendant McAdam and other F5 insiders, which was not permitted by F5's stock  
12 option plans. Moreover, the NSOs granted to directors under the 1998 Plan were all disclosed in  
13 proxy statements as having been granted at 100% of fair market value. See 2001 Proxy at 4; 2002  
14 Proxy at 2; 2004 Proxy at 5. The value of those options was not equal to the fair market value on the  
15 actual date of the grant. Contrary to the above representations, none of the options backdating  
16 acknowledged by F5 in November 2006 was ever approved by the shareholders, nor were  
17 shareholders ever aware of this illicit compensation.

18 **F5's 2002 Proxy Statement**

19 108. On or about January 28, 2002, F5 filed a Form 14A proxy statement with the SEC. In  
20 the proxy statement, the F5 Board of Directors, including defendants McAdam, Higginson, Guelich,  
21 Grinstein and Hussey, made the following representations about F5's stock option plans and granting  
22 practices:

23 Directors currently receive no cash compensation from the Company for their  
24 services as members of the Board of Directors. . . . From June 1999 through  
25 February 2000, eligible non-employee directors received automatic grants of options  
26 to purchase 5,000 shares annually under the Company's 1999 Non-Employee  
Directors' Option Plan ("Director Plan") *with an exercise price equal to the fair  
market value of the Common Stock on the date of grant. . . .*

In January 2001, each of Messrs. Higginson, Guelich and Grinstein was  
granted an option to purchase 7,500 shares of Common Stock at an exercise price of  
\$9.50 per share under the Company's 1998 Equity Incentive Plan (the "1998 Plan").  
In April 2001, each of Messrs. Higginson, Guelich and Grinstein was granted options

1 to purchase 15,000 shares of Common Stock at an exercise price of \$8.10 per share  
2 under the 1998 Plan.

3 \* \* \*

4 All non-employee directors who also serve on a board committee and who  
5 have been on the board for at least six months will receive options to purchase  
6 15,000 shares in May 2002. In subsequent years these directors will receive options  
7 to purchase 15,000 shares on the day of the Company's annual meeting. *These  
8 options . . . will have an exercise price equal to the closing price of the Company  
9 stock on the date of grant.*

10 109. Further, F5's Board of Directors, by and through its Compensation Committee  
11 (Higginson, Guelich and Grinstein), made the following representations about the purposes of F5's  
12 stock option plans:

13 The Compensation Committee believes that employee equity ownership  
14 provides significant motivation to executive officers to maximize value for the  
15 Company's shareholders and, therefore, periodically grants stock options under the  
16 Company's employee stock option plans. *Stock options are typically granted at the  
17 current market price and will only have value if the Company's stock price  
18 increases over the exercise price.*

19 The Compensation Committee determines the size and frequency of option  
20 grants for executive officers, based on recommendations from the Chief Executive  
21 Officer. Recommendations for options are based on the relative position and  
22 responsibilities of each executive officer, previous and expected contributions of  
23 each officer to the Company's success, and previous options grants to such executive  
24 officers.

25 110. Each of the above statements concerning F5's stock option plans and the value of the  
26 stock options on the dates of grant were false and misleading. This is because F5, in fact, backdated  
options to defendant McAdam and other F5 insiders, which was not permitted by F5's stock option  
plans. Contrary to the above representations, none of the options backdating acknowledged by F5 in  
November 2006 was ever approved by the shareholders, nor were shareholders ever aware of this  
illicit compensation.

### 23 **F5's 2003 Proxy Statement**

24 111. On or about January 8, 2003, F5 filed a Form 14A proxy statement with the SEC. In  
25 the proxy statement, the F5 Board of Directors, including defendants McAdam, Higginson, Guelich  
26

1 and Grinstein, made the following representations about F5's stock option plans and granting  
2 practices:

3 Directors other than audit committee members currently receive no cash  
4 compensation from the Company for their services as members of the Board of  
5 Directors. . . . From June 1999 through February 2000, eligible non-employee  
6 directors received automatic grants of options to purchase 5,000 shares annually  
under the Company's 1999 Non-Employee Directors' Option Plan ("Director Plan")  
*with an exercise price equal to the fair market value of the Common Stock on the  
date of grant. . . .*

7 In January 2001, each of Messrs. Higginson, Guelich and Grinstein was  
8 granted an option to purchase 7,500 shares of Common Stock at an exercise price of  
\$9.50 per share under the Company's 1998 Equity Incentive Plan (the "1998 Plan").  
9 In April 2001, each of Messrs. Higginson, Guelich and Grinstein was granted options  
10 to purchase 15,000 shares of Common Stock at an exercise price of \$8.10 per share  
under the 1998 Plan. In May 2002, each of Messrs. Higginson, Guelich and  
Grinstein was granted options to purchase 15,000 shares of Common Stock at an  
exercise price of \$11.12 per share under the 1998 Plan.

11 \* \* \*

12 All non-employee directors who also serve on a board committee receive  
13 options to purchase 15,000 shares of Common Stock on the day of the Company's  
annual meeting. *These options . . . will have an exercise price equal to the closing  
14 price of the Company stock on the date of grant.*

15 112. F5's Board of Directors, by and through its Compensation Committee (Higginson,  
16 Guelich and Grinstein), also made the following representations about the purposes of F5's stock  
17 option plans:

18 The Compensation Committee believes that employee equity ownership  
19 provides significant motivation to executive officers to maximize value for the  
Company's shareholders and periodically approves stock option grants under the  
20 Company's employee stock option plans. *Stock options are typically granted at the  
current market price and will only have value if the Company's stock price  
increases over the exercise price.*

21 The Compensation Committee reviews and approves recommendations made  
22 by the Chief Executive Officer on stock option grants for other executive officers.  
23 These recommendations for options are based on the relative position and  
responsibilities of each executive officer and previous and expected contributions of  
each officer to the Company's success.

24 113. Further, the F5 Board of Directors presented amendments to the 1998 Plan for  
25 shareholder approval. In connection with the amendments, the Board made the following  
26 representations about the administration of the 1998 Plan:

1 At the Annual Meeting, the shareholders of the Company will be asked to  
2 approve an amendment to the 1998 Equity Incentive Plan (the "1998 Plan") which, if  
3 approved, will increase the number of shares of Common Stock available for  
4 purchase under the 1998 Plan by 1,000,000 shares, to an aggregate of 6,300,000  
5 shares. . . .

6 The Board of Directors believes that the 1998 Plan has contributed to  
7 strengthening the incentive of participating employees to achieve the objectives of  
8 the Company and its shareholders by encouraging employees to acquire a greater  
9 proprietary interest in the Company. The Board of Directors believes that additional  
10 shares must be reserved for use under the 1998 Plan to enable the Company to attract  
11 and retain key employees through the granting of options under the 1998 Plan.

12 \* \* \*

13 Options granted under the 1998 Plan may be ISOs or NSOs. The term of a  
14 stock option granted under the 1998 Plan generally may not exceed 10 years. The  
15 Board of Directors determines the exercise price of options granted under the 1998  
16 Plan. *However, in the case of an ISO, the exercise price cannot be less than 100%*  
17 *of the fair market value of the Company's Common Stock on the date of grant and,*  
18 *in the case of an NSO, the exercise price cannot be less than 50% of the fair*  
19 *market value of the Company's Common Stock on the date of the grant. . . .*

20 \* \* \*

21 No person may be granted options under the 1998 Plan covering an aggregate  
22 of more than 200,000 shares of Common Stock in any calendar year.

23 \* \* \*

24 THE BOARD RECOMMENDS A VOTE "FOR" APPROVAL OF THIS  
25 PROPOSAL.

26 114. Each of the above statements concerning F5's stock option plans and the value of the  
stock options on the dates of grant were false and misleading. This is because F5, in fact, backdated  
options to defendant McAdam and other F5 insiders, which was not permitted by F5's stock option  
plans. Moreover, the NSOs granted to directors under the 1998 Plan were all disclosed in proxy  
statements as having been granted at 100% of fair market value. See 2001 Proxy at 4; 2002 Proxy at  
2; 2004 Proxy at 5. The value of those options was not equal to the fair market value on the actual  
date of the grant. Contrary to the above representations, none of the options backdating  
acknowledged by F5 in November 2006 was ever approved by the shareholders, nor were  
shareholders ever aware of this illicit compensation.

1 **F5's 2004 Proxy Statement**

2 115. On or about March 18, 2004, F5 filed a Form 14A proxy statement with the SEC. In  
3 the proxy statement, the F5 Board of Directors, consisting of defendants McAdam, Higginson,  
4 Guelich, Grinstein and Malone, made the following representations about F5's stock option plans  
5 and granting practices:

6 The Compensation Committee's function is to review and recommend the  
7 compensation for the executive officers and directors, including salaries, bonus levels  
8 and stock option grants.

8 \* \* \*

9 Beginning in fiscal year end 2001, all non-employee directors who also serve  
10 on a Board committee receive options to purchase 15,000 shares of Common Stock  
11 on the day of the Company's annual meeting. *These options . . . have an exercise*  
12 *price equal to the closing price of the Company stock on the date of grant.* Messrs.  
13 Higginson, Guelich, and Grinstein were each granted options to purchase 15,000  
14 shares of Common Stock under the Company's Amended and Restated 1998 Equity  
15 Incentive Plan (the "1998 Plan") in April 2001, May 2002 and February 2003 at  
16 exercise prices of \$8.10, \$11.12 and \$12.79, respectively.

17 116. Further, F5's Board of Directors, by and through its Compensation Committee  
18 (Higginson, Guelich and Malone), made the following representations about the purposes of F5's  
19 stock option plans:

20 The Compensation Committee believes that employee equity ownership  
21 provides significant motivation to executive officers to maximize value for the  
22 Company's shareholders and periodically approves stock option grants under the  
23 Company's employee stock option plans. *Stock options are typically granted at the*  
24 *current market price and will only have value if the Company's stock price*  
25 *increases over the exercise price.*

26 117. Further, the F5 Board of Directors presented amendments to the 1998 Plan for  
shareholder approval. In connection with the amendments, the Board made the following  
representations about the administration of the 1998 Plan:

At the Annual Meeting, the shareholders of the Company will be asked to  
approve an amendment to the 1998 Equity Incentive Plan (the "1998 Plan") which, if  
approved, will increase the number of shares of Common Stock available for  
purchase under the 1998 Plan by 2,000,000 shares, to an aggregate of 8,300,000  
shares. . . .

The Board of Directors believes that the 1998 Plan has contributed to  
strengthening the incentive of participating employees to achieve the objectives of



1 the Company and its shareholders by encouraging employees to acquire a greater  
2 proprietary interest in the Company. The Board of Directors believes that additional  
3 shares must be reserved for use under the 1998 Plan to enable the Company to attract  
4 and retain key employees through the granting of options under the 1998 Plan. The  
5 proposed increase in the number of shares under the 1998 Plan is not required or  
6 intended to cover awards previously made under the 1998 Plan. As such, no new  
7 plan benefits have been granted to date, and future awards under the 1998 Plan are  
8 not yet determinable.

9 \* \* \*

10 Options granted under the 1998 Plan may be ISOs or NSOs. . . . The Board  
11 of Directors determines the exercise price of options granted under the 1998 Plan.  
12 *However, in the case of an ISO, the exercise price cannot be less than 100% of the*  
13 *fair market value of the Common Stock on the date of grant and, in the case of an*  
14 *NSO, the exercise price cannot be less than 50% of the fair market value of the*  
15 *Company's Common Stock on the date of the grant. . . .*

16 \* \* \*

17 No person may be granted options under the 1998 Plan covering an aggregate  
18 of more than 200,000 shares of Common Stock in any calendar year.

19 \* \* \*

20 THE BOARD RECOMMENDS A VOTE "FOR" APPROVAL OF THIS  
21 PROPOSAL.

22 118. Additionally, the F5 Board of Directors made the following representations about the  
23 administration of its non-shareholder approved stock option plans:

24 In July 2000, the Board of Directors adopted the 2000 Employee Equity  
25 Incentive Plan, or the 2000 Plan, which provides for discretionary grants of non-  
26 qualified stock options, stock purchase awards and stock bonuses for employees and  
other service providers. . . .

*All options under the 2000 Plan . . . will have an exercise price of not less  
than the fair market value of the Company's stock on the date the option is  
granted. . . .*

. . . . In July 2003, the Board of Directors adopted the uRoam Acquisition  
Equity Incentive Plan, or uRoam Plan, in connection with the hiring of the former  
employees of uRoam, Inc. . . .

*All options under the uRoam Plan . . . will have an exercise price of not less  
than the fair market value of the Company's stock on the date the option is granted*

. . . .

25 119. Each of the above statements concerning F5's stock option plans and the value of the  
26 stock options on the dates of grant were false and misleading. This is because F5, in fact, backdated

1 options to defendant McAdam and other F5 insiders, which was not permitted by F5's stock option  
2 plans. Moreover, the NSOs granted to directors under the 1998 Plan were all disclosed in proxy  
3 statements as having been granted at 100% of fair market value. See 2001 Proxy at 4; 2002 Proxy at  
4 2; 2004 Proxy at 5. Contrary to the above representations, none of the options backdating  
5 acknowledged by F5 in November 2006 was ever approved by the shareholders, nor were  
6 shareholders ever aware of this illicit compensation.

7 **F5's 2005 Proxy Statement**

8 120. On or about January 7, 2005, F5 filed a Form 14A proxy statement with the SEC. In  
9 the proxy statement, the F5 Board of Directors, consisting of defendants McAdam, Higginson,  
10 Guelich, Grinstein, Malone and Ames, made the following representations about F5's stock option  
11 plans and granting practices:

12 The Compensation Committee's function is to recommend the compensation  
13 for the Chief Executive Officer and directors, including salaries, bonus levels and  
14 stock option grants and to review compensation proposals made by the Chief  
Executive Officer for the other executive officers.

15 \* \* \*

16 Beginning in fiscal year end 2001, all non-employee directors who also serve  
17 on a Board committee receive options to purchase 15,000 shares of Common Stock  
18 on the day of the Company's annual meeting. *These options . . . have an exercise*  
19 *price equal to the closing price of the Company stock on the date of grant.* Messrs.  
Higginson, Guelich, Grinstein, and Malone were each granted options to purchase  
15,000 shares of Common Stock under the Company's Amended and Restated 1998  
Equity Incentive Plan (the "1998 Plan") in April 2004 at an exercise price of \$28.10,  
respectively.

20 121. Further, F5's Board of Directors, by and through its Compensation Committee  
21 (Ames, Guelich and Grinstein), made the following representations about the purposes of F5's stock  
22 option plans:

23 The Compensation Committee believes that employee equity ownership  
24 provides significant motivation to executive officers to maximize value for the  
25 Company's shareholders and periodically approves stock option grants under the  
26 Company's employee stock option plans. *Stock options are typically granted at the*  
*current market price and will only have value if the Company's stock price*  
*increases over the exercise price.*

1 The Compensation Committee reviews and approves recommendations made  
2 by the Chief Executive Officer on stock option grants for other executive officers.  
3 These recommendations for options are based on the relative position and  
responsibilities of each executive officer and previous and expected contributions of  
each officer to the Company's success.

4 122. The F5 Board of Directors also presented the 2005 Equity Incentive Plan for  
5 shareholder approval. In connection with the proposal, the Board made the following  
6 representations about the administration of the 2005 Plan:

7 At the Annual Meeting, the shareholders of the Company will be asked to  
8 approve the 2005 Equity Incentive Plan which, if approved, will reserve 1,700,000  
9 shares of Common Stock (approximately 4.7% of the Company's outstanding capital  
stock as of January 3, 2005) for issuance under the 2005 Equity Incentive Plan.

10 \* \* \*

11 The Board of Directors strongly believes that approval of the 2005 Equity  
12 Incentive Plan is essential to the Company's continued success. We believe equity  
13 compensation gives employees and directors a stake in the future success of the  
14 Company and view it as a vital component of the Company's ability to offer  
competitive compensation packages within a highly aggressive industry. . . . The  
2005 Equity Incentive Plan is designed to assist us in recruiting, motivating and  
retaining talented employees and directors who will help us to continue achieving our  
business goals, including creating long-term value for shareholders.

15 Options granted under the 2005 Equity Incentive Plan are NSOs. . . . *The per*  
16 *share exercise price of all options must be at least equal to the fair market value of*  
*a share of Common Stock on the date the option is granted. . . .*

17 \* \* \*

18 THE BOARD RECOMMENDS A VOTE "FOR" APPROVAL OF THIS  
19 PROPOSAL.

20 123. Additionally, the F5 Board of Directors made the following representations about the  
21 administration of its non-shareholder approved stock option plans:

22 In July 2000, the Board of Directors adopted the 2000 Equity Incentive Plan, which  
23 provides for discretionary grants of non-qualified stock options, stock purchase  
awards and stock bonuses for employees and other service providers. . . .

24 All options under the 2000 Equity Incentive Plan . . . *will have an exercise*  
*price of not less than the fair market value of the Company's stock on the date the*  
25 *option is granted. . . .*

26 . . . In July 2003, the Board of Directors adopted the uRoam Equity Incentive  
Plan in connection with the hiring of the former employees of uRoam, Inc. . . .

1 All options under the uRoam Equity Incentive Plan . . . *were granted as non-*  
2 *qualified stock options with an exercise price equal to the fair market value of the*  
3 *Common Stock on the date of grant.*

4 124. Each of the above statements concerning F5's stock option plans and the value of the  
5 stock options on the dates of grant were false and misleading. This is because F5, in fact, backdated  
6 options to defendant McAdam and other F5 insiders, which was not permitted by F5's stock option  
7 plans. Moreover, the NSOs granted to directors under the 1998 Plan were all disclosed in proxy  
8 statements as having been granted at 100% of fair market value. *See* 2001 Proxy at 4; 2002 Proxy at  
9 2; 2004 Proxy at 5. Contrary to the above representations, none of the options backdating  
10 acknowledged by F5 in October 2006 was ever approved by the shareholders, nor were shareholders  
11 ever aware of this illicit compensation.

#### 11 **F5's 2006 Proxy Statement**

12 125. On or about January 20, 2006, F5 filed a Form 14A proxy statement with the SEC. In  
13 the proxy statement, the F5 Board of Directors, consisting of defendants McAdam, Higginson,  
14 Guelich, Grinstein, Malone and Ames, made the following representations about F5's stock option  
15 plans and granting practices:

16 The Compensation Committee's function is to recommend the compensation for the  
17 Chief Executive Officer and directors, including salaries, bonus levels and stock  
18 option grants, and to review compensation proposals made by the Chief Executive  
19 Officer for the other executive officers.

20 \* \* \*

21 Prior to February 24, 2005, each non-employee director who also served on a  
22 Board committee received an annual option to purchase 15,000 shares of Common  
23 Stock on the day of the Company's annual meeting. *These options . . . had an*  
24 *exercise price equal to the closing price of the Common Stock on the date of grant.*  
25 Messrs. Higginson, Guelich, Grinstein, and Malone were each granted options to  
26 purchase 15,000 shares of Common Stock under the Company's Amended and  
Restated 1998 Equity Incentive Plan (the "1998 Plan") in April 2004 at a per share  
exercise price of \$28.10, respectively.

126. Further, F5's Board of Directors, by and through its Compensation Committee  
(Ames, Guelich and Grinstein), made the following representations about the purposes of F5's stock  
option plans:

1 The Compensation Committee believes that equity ownership provides  
2 significant motivation to executive officers to maximize value for the Company's  
3 shareholders and periodically approves grants of equity compensation under the  
4 Company's equity incentive plans.

5 The Compensation Committee reviews and approves recommendations made  
6 by the CEO on grants of equity compensation for other executive officers. These  
7 recommendations are based on the relative position and responsibilities of each  
8 executive officer and previous and expected contributions of each officer to the  
9 Company's success.

10 127. The F5 Board of Directors also made the following representations about the  
11 administration of its non-shareholder approved stock option plans:

12 In July 2000, the Board of Directors adopted the 2000 Equity Incentive Plan, which  
13 provides for discretionary grants of non-qualified stock options, stock purchase  
14 awards and stock bonuses for employees and other service providers. . . .

15 All options under the 2000 Equity Incentive Plan . . . *will have an exercise  
16 price of not less than the fair market value of the Company's stock on the date the  
17 option is granted.* . . .

18 . . . In July 2003, the Board of Directors adopted the uRoam Equity Incentive  
19 Plan in connection with the hiring of the former employees of uRoam, Inc. . . .

20 All options under the uRoam Equity Incentive Plan . . . *were granted as non-  
21 qualified stock options with an exercise price equal to the fair market value of the  
22 Common Stock on the date of grant.*

23 128. Each of the above statements concerning F5's stock option plans and the value of the  
24 stock options on the dates of grant were false and misleading. This is because F5, in fact, backdated  
25 options to defendant McAdam and other F5 insiders, which was not permitted by F5's stock option  
26 plans. Moreover, the NSOs granted to directors under the 1998 Plan were all disclosed in proxy  
statements as having been granted at 100% of fair market value. See 2001 Proxy at 4; 2002 Proxy at  
2; 2004 Proxy at 5. Contrary to the above representations, none of the options backdating  
acknowledged by F5 in November 2006 was ever approved by the shareholders, nor were  
shareholders ever aware of this illicit compensation.

1 **F5's False Financial Reporting in Violation of GAAP**

2 129. As a result of defendants' improper backdating of stock options, defendants caused  
3 F5 to violate Generally Accepted Accounting Principles ("GAAP"), SEC regulations, and IRS rules  
4 and regulations.

5 130. F5's annual financial results were included in reports filed with the SEC and in other  
6 shareholder reports. In these reports, defendants represented that F5's financial results were  
7 presented in a fair manner and in accordance with GAAP.

8 131. Defendants' representations were false and misleading as to the financial information  
9 reported, as such financial information was not prepared in conformity with GAAP, nor was the  
10 financial information "a fair presentation" of the Company's financial condition and operations,  
11 causing the financial results to be presented in violation of GAAP and SEC rules.

12 132. GAAP consists of those principles recognized by the accounting profession as the  
13 conventions, rules, and procedures necessary to define accepted accounting practice at the particular  
14 time. Regulation S-X, to which the Company is subject as a registrant under the Exchange Act, 17  
15 C.F.R. §210.4-01(a)(1), provides that financial statements filed with the SEC which are not prepared  
16 in compliance with GAAP are presumed to be misleading and inaccurate.

17 **Violations of GAAP**

18 133. As F5 acknowledged on November 8, 2006, defendants caused the Company to  
19 understate its compensation expense by not properly accounting for its stock options under GAAP  
20 and thus materially overstated the Company's net earnings or materially understated its net loss  
21 between fiscal 1999 and 2006.

22 134. Under well-settled accounting principles in effect during the late 1990s and early  
23 2000s, F5 did not need to record an expense for options granted to employees at the then-current  
24 market price ("at-the-money"). The Company was, however, required to record an expense in its  
25 financial statements for any options granted below the then-current market price ("in-the-money").  
26 In order to provide F5 executives and employees with far more lucrative in-the-money options, while

1 avoiding having to inform shareholders about millions of dollars incurred by the Company in  
2 compensation expenses (and without paying the IRS millions of dollars in employment taxes),  
3 defendants systematically falsified Company records to create the false appearance that options had  
4 been granted at the market price on an earlier date.

5 135. During most of the relevant period, F5 accounted for stock options using the intrinsic  
6 method described in APB No. 25, *Accounting for Stock Issued to Employees*.<sup>8</sup> Under APB No. 25,  
7 employers were required to record as an expense on their financial statements the “intrinsic value” of  
8 a fixed stock option on its “measurement date.” An option that is in-the-money on the measurement  
9 date has intrinsic value, and the difference between its exercise price and the quoted market price  
10 must be recorded as compensation expense to be recognized over the vesting period of the option.  
11 Options that are at-the-money or out-of-the-money on the measurement date need not be expensed.  
12 Excluding non-employee directors, APB No. 25 required employers to record compensation  
13 expenses on options granted to non-employees irrespective of whether they were in-the-money or  
14 not on the date of grant.

15 **F5’s Restatement Is an Admission of Falsity**

16 136. As detailed above, the fact that F5 will need to revise and restate its net income and  
17 net losses is an admission that the financial statements originally issued were false when they were  
18 reported and that the misstatements were material.

19 **F5’s GAAP Violations Were Material**

20 137. F5’s false and misleading statements and omissions regarding its stock option  
21 accounting were material, particularly in light of SEC guidance on materiality. SEC Staff  
22

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23 <sup>8</sup> APB No. 25 was later superseded by Statement of Financial Accounting Standards (SFAS)  
24 No. 123, *Share-Based Payment*. SFAS No. 123 went into effect for large publicly traded companies  
25 for all interim or annual reporting periods that began after June 15, 2005. Under SFAS No. 123,  
26 companies are required to account for their stock option grants using the fair market value method  
rather than the intrinsic value method. The new method requires a company to expense all employee  
stock options when granted.

Accounting Bulletin ("SAB") Topic 1M, Materiality, summarizes GAAP definitions of materiality.<sup>9</sup> Among other items, SAB Topic 1M says: "A matter is 'material' if there is a substantial likelihood that a reasonable person would consider it important." It also stresses that materiality requires qualitative, as well as quantitative, considerations. For example, if a known misstatement would cause a significant market reaction that reaction should be taken into account in determining the materiality of the misstatement.

138. SAB Topic 1M further states:

Among the considerations that may well render material a quantitatively small misstatement of a financial statement item are –

\* \* \*

- whether the misstatement masks a change in earnings or other trends
- whether the misstatement hides a failure to meet analysts' consensus expectations for the enterprise

\* \* \*

- whether the misstatement concerns a segment or other portion of the registrant's business that has been identified as playing a significant role in the registrant's operations or profitability.

139. SAB Topic 1M also says that an intentional misstatement of even immaterial items may be illegal and constitute fraudulent financial reporting.

140. F5's misstatements satisfy these criteria and thus were material from both a quantitative and qualitative perspective.

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<sup>9</sup> SAB Topic 1M, Materiality, represents the codification of certain SABs, including SAB No. 99, Materiality, as of May 9, 2003. SAB No. 99 was effective August 12, 1999. On September 13, 2006, the SEC issued SAB 108 – new guidance for determining materiality of past errors. This new standard is effective for financial statements for fiscal years ending after November 15, 2006. Under SAB 108, the fundamental principles surrounding materiality remain consistent with materiality under the prior guidance. However, this new guidance requires companies to evaluate known errors to a finer degree than in the past.



1 **F5's Financial Statements Violated**  
2 **Fundamental Concepts of GAAP**

3 141. Due to these accounting improprieties, defendants caused F5 to present its financial  
4 results and statements in a manner that violated GAAP, which are described by the following  
5 statements:

6 (a) The principle that interim financial reporting should be based upon the same  
7 accounting principles and practices used to prepare annual financial statements (APB No. 28, ¶10);

8 (b) The principle that financial reporting should provide information that is useful  
9 to existing and potential investors and creditors and other users in making rational investment, credit  
10 and similar decisions (Financial Accounting Standards Board ("FASB") Statement of Concepts  
11 No. 1, ¶34);

12 (c) The principle that financial reporting should provide information about the  
13 economic resources of an enterprise, the claims to those resources, and the effects of transactions,  
14 events and circumstances that change resources and claims to those resources (FASB Statement of  
15 Concepts No. 1, ¶40);

16 (d) The principle that financial reporting should provide information about how  
17 management of an enterprise has discharged its stewardship responsibility to stockholders for the use  
18 of enterprise resources entrusted to it. To the extent that management offers securities of the  
19 enterprise to the public, it voluntarily accepts wider responsibilities for accountability to prospective  
20 investors and to the public in general (FASB Statement of Concepts No. 1, ¶50);

21 (e) The principle that financial reporting should be reliable in that it represents  
22 what it purports to represent (FASB Statement of Concepts No. 2, ¶¶58-59);

23 (f) The principle of completeness, which means that nothing material is left out of  
24 the information that may be necessary to insure that it validly represents underlying events and  
25 conditions (FASB Statement of Concepts No. 2, ¶79); and  
26

1 (g) The principle that conservatism be used as a prudent reaction to uncertainty to  
2 try to ensure that uncertainties and risks inherent in business situations are adequately considered  
3 (FASB Statement of Concepts No. 2, ¶¶95, 97).

4 142. Further, the undisclosed adverse information concealed by defendants about their  
5 illegal stock option backdating scheme is the type of information which, because of SEC regulations,  
6 regulations of the national stock exchanges and customary business practice, is expected by investors  
7 and securities analysts to be disclosed, and is known by corporate officials and their legal and  
8 financial advisors to be the type of information which is expected to be and must be disclosed.

#### 9 **Violations of SEC Regulations**

10 143. As detailed above, defendants caused F5 to violate SEC regulations by failing to  
11 disclose that the Company's directors and executives had been granted backdated stock options to  
12 themselves and other F5 insiders.

13 144. Under SEC Regulations, Item 8 of Form 14-A and Item 11 of Form 10-K, an issuer  
14 must furnish information required by Item 402 of Regulation S-K [17 C.F.R. §229.402]. Item  
15 402(b) and (c) require a company to provide both a summary compensation table and an option/SAR  
16 grants table identifying the compensation of the named executive officers – the company's CEO and  
17 its next four most highly paid executives. Item 402 requires particularized disclosures involving a  
18 company's stock option grants in the last fiscal year. In the summary compensation table, the issuer  
19 must identify in a column "Other Annual Compensation" received by the named executives that is  
20 not properly categorized as salary or bonus, including any "[a]bove-market or preferential earnings  
21 on restricted stock, options, SARs or deferred compensation" paid to the officer during the period.  
22 Item 402(b)(2)(iii)(C)(2). In the option grant table, the issuer must identify in a column "[t]he per-  
23 share exercise or base price of the options . . . . If such exercise or base price is less than the market  
24 price of the underlying security on the date of grant, a separate, adjoining column shall be added  
25 showing market price on the date of grant." Item 402(c)(2)(iv).

1 145. Defendants caused F5 to violate SEC regulations by failing to disclose that the  
2 Company's executive officers and directors had been granted options with exercise prices below the  
3 market value on the date of the grant.

4 **F5's False and Misleading Annual Reports**

5 146. The chart below illustrates F5's false and misleading annual fiscal financial results  
6 which materially understated its compensation expenses and thus materially overstated its earnings  
7 and materially understated its losses:

FISCAL YEAR	REPORTED EARNINGS (LOSS) (in thousands)	REPORTED DILUTED EARNINGS (LOSS) PER SHARE
1999	\$ (4,344)	\$(0.42)
2000	\$ 13,650	\$0.59
2001	\$(30,790)	\$(1.36)
2002	\$ (8,610)	\$(0.34)
2003	\$ 4,087	\$0.14
2004	\$ 32,953	\$0.92
2005	\$ 51,733	\$1.34

14 **F5's 1999 Form 10-K**

15 147. On or about December 28, 1999, F5 filed its 1999 Report on Form 10-K with the  
16 SEC. The Form 10-K included F5's fiscal 1999 financial statements, which were materially false  
17 and misleading and presented in violation of GAAP, due to improper accounting for the backdated  
18 stock options. As a result, F5's compensation expense was materially understated and its net loss  
19 was materially understated, as the Company admitted on November 8, 2006. The 1999 Form 10-K  
20 was signed by defendants Higginson, Guelich, Grinstein, Amdahl and Hussey.

21 **F5's 2000 Form 10-K**

22 148. On or about December 13, 2000, F5 filed its 2000 Report on Form 10-K with the  
23 SEC. The Form 10-K included F5's fiscal 2000 financial statements, which were materially false  
24 and misleading and presented in violation of GAAP, due to improper accounting for the backdated  
25 stock options. As a result, F5's compensation expense was materially understated and its net  
26 earnings were materially overstated, as the Company admitted on November 8, 2006. The 2000  
Form 10-K was signed by defendants McAdam, Higginson, Guelich, Grinstein, Amdahl and Hussey.

1 **F5's 2001 Form 10-K**

2 149. On or about December 28, 2001, F5 filed its 2001 Report on Form 10-K with the  
3 SEC. The Form 10-K included F5's fiscal 2001 financial statements, which were materially false  
4 and misleading and presented in violation of GAAP, due to its improper accounting for the  
5 backdated stock options. As a result, F5's compensation expense was materially understated and its  
6 net loss was materially understated, as the Company admitted on November 8, 2006. The 2001  
7 Form 10-K was signed by defendants McAdam, Higginson, Guelich, Grinstein, Coburn and Hussey.

8 **F5's 2002 Form 10-K**

9 150. On or about December 17, 2002, F5 filed its 2002 Report on Form 10-K with the  
10 SEC. The Form 10-K included F5's fiscal 2002 financial statements, which were materially false  
11 and misleading and presented in violation of GAAP, due to its improper accounting for the  
12 backdated stock options. As a result, F5's compensation expense was materially understated and its  
13 net loss was materially understated, as the Company admitted on November 8, 2006. The 2002  
14 Form 10-K, signed by defendants McAdam, Higginson, Guelich, Grinstein, Coburn and Hussey.

15 **F5's 2003 Form 10-K**

16 151. On or about October 29, 2003, F5 filed its 2003 Report on Form 10-K with the SEC.  
17 The Form 10-K included F5's fiscal 2003 financial statements which were materially false and  
18 misleading and presented in violation of GAAP, due to improper accounting for the backdated stock  
19 options. As a result, F5's compensation expense was materially understated and its net earnings  
20 were materially overstated, as the Company admitted on November 8, 2006. The 2003 Form 10-K  
21 was signed by defendants McAdam, Higginson, Guelich, Grinstein, Malone, Coburn and Hussey.

22 **F5's 2004 Form 10-K**

23 152. On or about December 6, 2004, F5 filed its 2004 Report on Form 10-K with the SEC.  
24 The Form 10-K included F5's fiscal 2004 financial statements, which were materially false and  
25 misleading and presented in violation of GAAP, due to improper accounting for the backdated stock  
26 options. As a result, F5's compensation expense was materially understated and its net earnings

1 were materially overstated, as the Company admitted on November 8, 2006. The 2004 Form 10-K  
2 was signed by defendants McAdam, Higginson, Guelich, Grinstein, Malone, Ames and Coburn.

3 **F5's 2005 Form 10-K**

4 153. On or about December 12, 2005, F5 filed its 2005 Report on Form 10-K with the  
5 SEC. The Form 10-K included F5's fiscal 2005 financial statements, which were materially false  
6 and misleading and presented in violation of GAAP, due to its improper accounting for the  
7 backdated stock options. As a result, F5's compensation expense was materially understated and its  
8 net earnings were materially overstated, as the Company admitted on November 8, 2006. The 2005  
9 Form 10-K was signed by defendants McAdam, Higginson, Guelich, Grinstein, Malone, Ames and  
10 Rodriguez.

11 154. As F5's CEO, CFO and Controller, defendants McAdam (CEO), Coburn (CFO) and  
12 Rodriguez (Controller) signed SOX §302 certifications falsely stating that F5's Forms 10-K did not  
13 contain any material misstatements or omit material information and that the reports fairly presented  
14 in all material respects F5's financial condition and results of operations.<sup>10</sup> These statements were  
15 untrue at the time they were made due to the unlawful stock option backdating scheme particularized  
16 herein. Among other things, these defendants knew that the certifications were false and misleading  
17 because they and their fellow F5 executives had granted and/or received backdated option grants, in  
18 direct violation of the Company's shareholder stock option plans.

19 155. Defendants McAdam, Coburn and Rodriguez knew, or were reckless in not knowing,  
20 that these certifications were materially false or misleading. As described herein, F5's financial  
21 statements for those years did not fairly present F5's financial condition because the Forms 10-K  
22 failed to account for defendants' in-the-money grants as compensation expense and thus, materially

23 \_\_\_\_\_  
24 <sup>10</sup> Defendant McAdam signed SOX certifications attached to the following filings: December 17, 2002,  
25 October 29, 2003, January 26, 2004, December 6, 2004, December 12, 2005, December 15, 2005 and December 11,  
26 2006. Defendant Coburn signed SOX certifications attached to the following filings: December 17, 2002, October 29,  
2003, January 26, 2004 and December 6, 2004. Defendant Rodriguez signed SOX certifications attached to the  
following filings: December 12, 2005, December 15, 2005 and December 11, 2006.

1 overstated net income and earnings and/or materially understated net loss. The chart below  
2 illustrates which defendants signed F5's annual reports and SOX certifications.

Year	Signatories	SOX Certification
1999	Higginson, Guelich, Grinstein, Amdahl, Hussey	
2000	McAdam, Higginson, Guelich, Grinstein, Amdahl, Hussey	
2001	McAdam, Higginson, Guelich, Grinstein, Coburn, Hussey	
2002	McAdam, Higginson, Guelich, Grinstein, Coburn, Hussey	McAdam, Coburn
2003	McAdam, Higginson, Guelich, Grinstein, Coburn, Malone, Hussey	McAdam, Coburn
2004	McAdam, Higginson, Guelich, Grinstein, Coburn, Malone, Ames	McAdam, Coburn
2005	McAdam, Higginson, Guelich, Grinstein, Rodriguez Malone, Ames	McAdam, Rodriguez
2006	McAdam, Higginson, Guelich, Grinstein, Malone, Rodriguez, Ames	McAdam, Rodriguez

#### **TOLLING OF APPLICABLE LIMITATION PERIODS**

156. The claims asserted herein are timely. As an initial matter, defendants wrongfully concealed their manipulation of F5's stock option plans, through a continuous, integrated and systematic stock option backdating scheme, by issuing false and misleading proxy statements, by falsely reassuring F5's shareholders that F5's option grants were being administered in accordance with the Company's stock option plans, and by failing to disclose that backdated options were, in fact, actually issued on dates other than those disclosed, and that strategically-timed option grants were issued based on the manipulation of insider information that ensured the true fair market value of the Company's stock was, in fact, higher than the publicly traded price on the date of the option grant. Defendants fraudulently concealed their wrongdoing from shareholders in documents that they caused to be filed with the SEC. Plaintiff shareholders are entitled to rely on the integrity of publicly filed documents and are not required to perform a sophisticated statistical analysis to uncover defendants' scheme.

157. F5's shareholders and the investing public had no reason to know of defendants' breach of their fiduciary duties until at least May 2006, when it was first reported that defendants had caused F5 to engage in a secret stock option backdating scheme.

158. Finally, as fiduciaries of F5 and its shareholders, defendants cannot rely on any limitations defense where they withheld from F5's shareholders the facts that give rise to the claims asserted herein, *i.e.*, that the option grant dates to defendants had been manipulated to maximize the profit for the grant recipients.

#### UNLAWFUL INSIDER SALES

159. Between 1999 and 2006, defendants exercised many backdated options and sold over \$161.2 million worth of F5 stock in violation of the insider trading laws. The details of their stock sales are set forth below:

Defendant	Dates of Sales	Shares Sold	Proceeds Received
Ames	2/15/2005	10,000	\$548,800
Amdahl	8/17/00	10,000	\$520,300
Coburn	2/2/04-6/1/05	365,000	\$14,966,570
Grinstein	2/10/04-12/13/05	62,500	\$2,888,052
Guelich	2/13/02-1/24/06	70,880	\$3,108,983
Higginson	10/8/99-2/9/06	156,300	\$6,641,833
Eames	11/14/01-8/1/06	386,146	\$16,645,630
McAdam	11/21/02-2/3/06	1,205,000	\$42,965,396
Goldman	9/9/99-8/3/04	352,500	\$10,529,103
Helsel	9/29/99-5/3/05	289,703	\$8,212,502
Hussey	6/9/99-5/31/03	478,000	\$25,829,144
Pancottine	3/7/03-2/1/06	475,878	\$19,151,122
Reinland	11/18/05-02/01/06	18,933	\$1,129,370
Reiter	10/30/01-02/15/06	226,491	\$8,418,470
Rodriguez	11/18/05-05/01/06	10,287	\$595,564
<b>TOTAL</b>		<b>4,062,618</b>	<b>\$161,264,878</b>

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1 issued under the backdating scheme was likely nondeductible under §162(m) of the Internal Revenue  
2 Code.

3 165. On May 16, 2006, CFRA published a report on stock option backdating which listed  
4 F5 as a company at risk for such practices. On May 22, 2006, F5 received a subpoena from the  
5 United States Attorney for the Eastern District of New York requesting that the Company provide  
6 the court with documents relating to its stock option grants. On the same day, the Company received  
7 notice informing it that the SEC is conducting an informal inquiry into its stock option grants and  
8 requesting documents related to the granting of stock options from January 1, 1997 through the  
9 present.

10 166. On July 20, 2006, F5 announced that an internal investigation has "identified at least  
11 one occasion on which the accounting measurement date for option awards granted to certain  
12 employees, officers and directors of the [C]ompany was different from the correct accounting  
13 measurement date determined under applicable accounting rules," and "[a]s a result, the [C]ompany  
14 expects to record an additional non-cash, stock-based compensation expense related to these  
15 options." Also, on July 20, 2006, F5 reported that, due to the stock option investigation, the  
16 Company would be unable to timely file its SEC Form 10-Q for the second quarter of 2006.

17 167. On October 25, 2006, F5 disclosed that its stock options for the period 1999-2006 had  
18 been backdated and, as a result, the Company will restate its financial statements for 1999-2005 to  
19 reflect material non-cash compensation expenses arising from defendants' unlawful stock option  
20 backdating scheme.

21 168. On November 8, 2006, F5 disclosed the key findings of its internal investigation,  
22 which concluded, "that the recorded grant dates for certain stock options granted during fiscal years  
23 1999 through 2004 should not be relied upon as the measurement date for accounting purposes and  
24 that the accounting treatment used for the vesting of certain stock options was incorrect," and "F5  
25 will be required to record an additional non-cash, stock-based compensation expense of  
26

1 approximately \$22.9 million, in the aggregate, for fiscal years 1999 through 2006,” and that “F5 has  
2 spent approximately \$7.0 million in legal and accounting fees related to this inquiry.”

### 3 DERIVATIVE ALLEGATIONS

4 169. Plaintiffs incorporate ¶¶1-168.

5 170. Plaintiffs bring this action derivatively on behalf of F5 to redress injuries suffered,  
6 and yet to be suffered, by the Company as a direct and proximate result of the breaches of fiduciary  
7 duty and other violations of law. F5 is named as a nominal defendant solely in a derivative capacity.

8 171. Plaintiffs are shareholders of F5 common stock and will adequately and fairly  
9 represent the interests of the Company in this litigation.

10 172. The secret backdating scheme detailed herein subjects, and will persist in subjecting,  
11 F5 to continuing harm because the adverse consequences of the injurious effects are still in effect.  
12 Defendants’ scheme harmed the Company by, among other things, causing it to report false financial  
13 information to the investing public by repeatedly backdating stock option grants and falsifying  
14 related paperwork.

15 173. At all relevant times, the wrongful actions complained of herein were unlawfully  
16 concealed from F5 shareholders until at least May 2006.

17 174. On the date of the first complaint filed by plaintiffs (June 8, 2006), the Board of  
18 Directors of F5 consisted of six members: defendants McAdam, Higginson, Guelich, Grinstein,  
19 Ames and Malone.

20 Defendant	Tenure	Audit Committee	Compensation Committee	Granted/Received Backdated Options	Signed Restated Financials	Insider Sales
21 McAdam	2000-Present			√	√	√
22 Higginson	1996-Present	√	√	√	√	√
23 Guelich	1999-Present	√	√	√	√	√
24 Grinstein	1999-Present	√	√	√	√	√

Malone	2003- Present			√	√	
Ames	2004- Present		√		√	√

175. Demand is excused because the F5 Board of Directors played a central role in the events leading up to the backdating debacle that has ensnarled F5 and the Board members face a substantial likelihood of personal liability as a result of their actions and conscious failures to act. More specifically, a pre-suit demand on the F5 Board of Directors is excused because the directors violated the federal securities and proxy laws by engaging in a secret, multi-year scheme of backdating stock option grants to themselves and others and by using F5's proxy statements and SEC filings to conceal and disguise the fact that such backdating was occurring.

176. Based upon the facts set forth throughout this Complaint, applicable law and the longstanding rule that equity does not compel a useless and futile act, a pre-filing demand upon the F5 Board of Directors to institute this action against the officers and members of the F5 Board of Directors is excused as futile. A pre-filing demand would be a useless and futile act because:

(a) A pre-suit demand upon the F5 Board of Directors is excused because a majority of its members personally and financially benefited from the unlawful backdating scheme particularized in this Complaint. For example, defendant McAdam stood on both sides of several stock option grants, including the backdated grants on July 24, 2000, January 1, 2001, April 27, 2001, May 6, 2002, May 8, 2003 and April 30, 2004 to himself and other F5 executives and directors. He also profited handsomely by selling over 1.2 million shares of his personal F5 stock, some via exercise of the backdated stock options that he received, for over \$42.9 million in unlawful insider trading proceeds in violation of the securities laws. Defendant McAdam sold these shares while in possession of non-public information, *i.e.*, the secret backdating scheme particularized herein which was causing F5's compensation expense to be materially understated, its net income to be materially overstated;

(b) Defendants Higginson, Guelich, Grinstein and Malone were members of the Compensation Committee and were responsible for determining the size, frequency, and recipients

1 of stock option grants. Higginson and Guelich granted backdated stock options on October 1, 1999,  
2 February 10, 2000, July 24, 2000, January 1, 2001, April 20, 2001, April 27, 2001, May 6, 2002,  
3 May 8, 2003 and April 30, 2004. Grinstein granted backdated stock options on October 1, 1999,  
4 February 10, 2000, July 24, 2000, January 1, 2001, April 20, 2001, April 27, 2001, May 6, 2002 and  
5 May 8, 2003. Malone granted backdated stock options on April 30, 2004. Accordingly, Higginson,  
6 Guelich, Grinstein and Malone face a substantial likelihood of liability for granting backdated stock  
7 options and cannot disinterestedly consider a demand;

8 (c) In addition, defendants Higginson, Guelich and Grinstein also stood on both  
9 sides of several stock option grants because they each received backdated stock option grants on  
10 January 1, 2001, April 20, 2001 and May 6, 2002. As a result of their receipt of backdated options,  
11 defendants Higginson, Guelich and Grinstein have been unjustly enriched by the backdating scheme  
12 particularized in this Complaint. They are not disinterested in the outcome of this litigation because  
13 they face a substantial likelihood of liability for violating the federal securities and proxy laws, as  
14 well as participating in and financially benefiting from the unlawful backdating scheme  
15 particularized herein;

16 (d) Defendants Ames and Rodriguez also profited handsomely from the  
17 backdating scheme. While in possession of non-public information, *i.e.*, the secret backdating  
18 scheme particularized herein which was causing F5's compensation expenses to be materially  
19 understated, its net income to be materially overstated and its net loss to be materially understated,  
20 defendants Ames and Rodriguez sold 10,000 and 10,287 shares of their personal F5 stock,  
21 respectively, for unlawful insider trading proceeds of over \$548,800 and \$595,000, in violation of  
22 the federal securities laws. As a result of their unlawful insider trading, defendants Ames and  
23 Rodriguez face a substantial likelihood of liability to F5 based on their participation in, and financial  
24 profits from, the continuous and systematic backdating scheme particularized herein. Thus, they are  
25 not disinterested in the outcome of this litigation, and therefore, cannot and will not, fairly and/or  
26

1 objectively evaluate any demand, let alone prosecute, the claims for damages and other relief arising  
2 from defendants' unlawful backdating scheme that plaintiffs may have made;

3 (e) A pre-suit demand on the F5 Board of Directors is also futile and, therefore,  
4 excused because all of its members signed one or more of F5's annual reports on Forms 10-K  
5 between 1999 and 2006 that contained false and misleading financial results and information.  
6 Defendant McAdam signed F5's Forms 10-K from at least 2000-2006. Defendants Higginson,  
7 Guelich and Grinstein each signed F5's Forms 10-K for at least 1999-2006. Defendant Malone  
8 signed F5's Forms 10-K for at least 2003-2006. Defendant Ames signed F5's Forms 10-K for at  
9 least 2004-2006;

10 (f) In each of these Forms 10-K, defendants represented that the financial  
11 information contained therein was accurate. Instead, however, while under the stewardship of  
12 defendants McAdam, Higginson, Guelich, Grinstein, Malone and Ames, the secret backdating  
13 scheme particularized in this Complaint was being perpetrated upon and causing great injury to F5.  
14 More specifically, as F5 admitted on October 25, 2006 that due to defendants' backdating scheme,  
15 the Company's Forms 10-K from 1999-2005 materially overstated F5's compensation expenses and  
16 materially overstated its net income and materially understated its net losses;

17 (g) The members of F5's Board of Directors have demonstrated their  
18 unwillingness and/or inability to act in compliance with their fiduciary obligations and/or to sue  
19 themselves and/or their fellow directors and allies in the top ranks of the corporation for the  
20 violations of law complained of herein. These are people they have developed professional  
21 relationships with, who are their friends and with whom they have entangling financial alliances,  
22 interests and dependencies, and, therefore, they are not able to and will not vigorously prosecute any  
23 such action;

24 (h) The F5 Board of Directors and senior management participated in, approved  
25 and/or permitted the wrongs alleged herein to have occurred and participated in efforts to conceal or  
26 disguise those wrongs from F5's stockholders or recklessly and/or negligently disregarded the

1 wrongs complained of herein, and are therefore not disinterested parties. As a result of their access  
2 to and review of internal corporate documents, or conversations and connections with other  
3 corporate officers, employees, and directors and attendance at management and/or Board meetings,  
4 each of the defendants knew the adverse non-public information regarding the improper stock option  
5 grants and financial reporting. Pursuant to their specific duties as Board members, defendants are  
6 charged with managing the Company and to conducting its business affairs. Defendants breached  
7 the fiduciary duties that they owed to F5 and its shareholders in that they failed to prevent and  
8 correct the improper stock option granting and financial reporting. Certain directors are also  
9 dominated and controlled by other directors and cannot act independently of them. Thus, the F5  
10 Board cannot exercise independent, objective judgment in deciding whether to bring this action or  
11 whether to vigorously prosecute this action because each of its members participated personally in  
12 the wrongdoing or are dependent upon other defendants who did;

13 (i) The acts complained of constitute violations of the fiduciary duties owed by  
14 F5's officers and directors and these acts are incapable of ratification;

15 (j) The members of F5's Board of Directors have benefited, and will continue to  
16 benefit, from the wrongdoing herein alleged and have engaged in such conduct to preserve their  
17 positions of control and the perquisites derived thereof, and are incapable of exercising independent,  
18 objective judgment in deciding whether to bring this action;

19 (k) Any suit by the current directors of F5 to remedy these wrongs would likely  
20 further expose the liability of defendants under the federal securities laws, which could result in  
21 additional civil and/or criminal actions being filed against one or more of the defendants, thus, they  
22 are hopelessly conflicted in making any supposedly independent determination whether to sue  
23 themselves;

24 (l) F5 has been and will continue to be exposed to significant losses due to the  
25 wrongdoing complained of herein, yet the current Board of Directors has not filed any lawsuits  
26

1 against itself or others who were responsible for that wrongful conduct to attempt to recover for F5  
2 any part of the damages F5 suffered and will suffer thereby;

3 (m) In order to properly prosecute this lawsuit, it would be necessary for the  
4 directors to sue themselves and the other defendants, requiring them to expose themselves and their  
5 comrades to millions of dollars in potential civil liability and criminal sanctions, or IRS penalties,  
6 while the Company is being investigated by both the U.S. Attorney's office and the SEC. This they  
7 will not do;

8 (n) F5's current and past officers and directors are protected against personal  
9 liability for their acts of mismanagement, waste and breach of fiduciary duty alleged in this  
10 Complaint by directors' and officers' liability insurance which they caused the Company to purchase  
11 for their protection with corporate funds, *i.e.*, monies belonging to the stockholders of F5. However,  
12 due to certain changes in the language of directors' and officers' liability insurance policies in the  
13 past few years, the directors' and officers' liability insurance policies covering the defendants in this  
14 case contain provisions which eliminate coverage for any action brought directly by F5 against these  
15 defendants, known as, *inter alia*, the "insured versus insured exclusion." As a result, if these  
16 directors were to sue themselves or certain of the officers of F5, there would be no directors' and  
17 officers' insurance protection and thus, this is a further reason why they will not bring such a suit.  
18 On the other hand, if the suit is brought derivatively, as this action is brought, such insurance  
19 coverage exists and will provide a basis for the Company to effectuate a recovery; and

20 (o) In order to bring this action for breaching their fiduciary duties, the members  
21 of the F5 Board of Directors would have been required to sue themselves and/or their fellow  
22 directors and allies in the top ranks of the Company, who are their personal friends and with whom  
23 they have entangling financial alliances, interests and dependencies, which they would not do.

24 177. Plaintiffs have not made any demand on shareholders of F5 to institute this action  
25 since such demand would be a futile and useless act for the following reasons:  
26

1 (a) F5 is a publicly traded company with approximately 39.4 million shares  
2 outstanding, and thousands of shareholders;

3 (b) Making demand on such a number of shareholders would be impossible for  
4 plaintiffs who have no way of finding out the names, addresses or phone numbers of shareholders;  
5 and

6 (c) Making demand on all shareholders would force plaintiffs to incur huge  
7 expenses, assuming all shareholders could be individually identified.

8 **COUNT I**

9 **(Against All Defendants for Violation of §14(a) of the Exchange Act)**

10 178. Plaintiffs incorporate ¶¶1-177.

11 179. Defendants, by use of the mails or by any means or instrumentality of interstate  
12 commerce or of any facility of a national securities exchange or otherwise, knowingly, negligently or  
13 with deliberate recklessness, solicited by means of a proxy statement, form of proxy, notice of  
14 meeting or other communication, written or oral, containing statements which, at the time and in the  
15 light of the circumstances under which they were made, were false and misleading with respect to  
16 material facts, or omitted to state material facts necessary in order to make the statements therein not  
17 false or misleading or necessary to correct statements in earlier communications with respect to the  
18 solicitation of the proxy for the same meeting or subject matter which was false or misleading.

19 180. By engaging in the conduct alleged above, defendants violated §14(a) of the  
20 Exchange Act and Exchange Act Rule 14a-9.

21 181. Plaintiffs, as shareholders of F5, seek damages and other relief for F5.

22 **COUNT II**

23 **(Against Defendants McAdam, Coburn, Hussey, Reinland and Rodriguez  
24 for Violation of §10(b) of the Exchange Act)**

25 182. Plaintiffs incorporate ¶¶1-177.

26 183. Throughout the relevant period, defendants individually and in concert, directly and  
indirectly, by the use and means of instrumentalities of interstate commerce and/or of the mails,



1 engaged and participated in a continuous course of conduct designed to divert hundreds of millions  
2 of dollars to defendants via improper option grants.

3 184. Defendants employed devices, schemes and artifices to defraud while in possession of  
4 material, adverse non-public information and engaged in acts, practices and a course of conduct that  
5 included the making of, or participation in the making of, untrue and/or misleading statements of  
6 material facts and/or omitting to state material facts necessary in order to make the statements made  
7 about F5 not misleading.

8 185. Defendants, as top executive officers and directors of the Company, are liable as  
9 direct participants in the wrongs complained of herein. Through their positions of control and  
10 authority as officers of the Company, each of the defendants was able to and did control the conduct  
11 complained of herein and the content of the public statements disseminated by F5.

12 186. Defendants acted with scienter throughout the relevant period, in that they either had  
13 actual knowledge of the misrepresentations and/or omissions of material facts set forth herein, or  
14 acted with reckless disregard for the truth in that they failed to ascertain and to disclose the true  
15 facts, even though such facts were available to them. Defendants were among the senior  
16 management of the Company, and were therefore directly responsible for the false and misleading  
17 statements and/or omissions disseminated to the public through press releases, news reports and  
18 filings with the SEC.

19 187. Each of the defendants participated in a scheme to defraud with the purpose and  
20 effect of defrauding F5.

21 188. By virtue of the foregoing, defendants have violated §10(b) of the Exchange Act, and  
22 Rule 10b-5 promulgated thereunder.

23 189. Plaintiffs, as shareholders of F5, seek damages and other relief for F5.  
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**COUNT III**

**(Against All Defendants for Violation of §20(a) of the Exchange Act)**

190. Plaintiffs incorporate ¶¶1-177.

191. Defendants, by virtue of their positions with F5 and their specific acts, were, at the time of the wrongs alleged herein, controlling persons of F5 within the meaning of §20(a) of the Exchange Act. They had the power and influence and exercised the same to cause F5 to engage in the illegal conduct and practices complained of herein.

192. Plaintiffs, as shareholders of F5, seek damages and other relief for F5.

**COUNT IV**

**(Against Defendants McAdam, Coburn, Reinland and Rodriguez  
for Disgorgement Under Sarbanes-Oxley Act of 2002)**

193. Plaintiffs incorporate ¶¶1-177.

194. Pursuant to §304 of the Sarbanes-Oxley Act of 2002, because the Company must restate its financials for at least fiscal 2003-2005, due to material noncompliance with GAAP, as a result of false and misleading financial statements, defendant McAdam, as the Company's CEO, and defendant Coburn, the Company's CFO, during the restatement period, are required to reimburse the Company for all bonuses or other incentive-based or equity-based compensation received by them from the Company during fiscal 2003-2005. Between fiscal 2003-2005, McAdam received over \$1.7 million in salary and bonus and 260,000 incentive stock option awards from F5 and Coburn received \$942,009 in salary and bonus and 90,000 incentive stock option awards from F5.

**COUNT V**

**(Against All Defendants for Breach of Fiduciary Duties  
and Aiding and Abetting Breach of Fiduciary Duties)**

195. Plaintiffs incorporate ¶¶1-177.

196. Defendants engaged in conduct in breach of their fiduciary duties of good faith, honesty and loyalty owed to F5.

1 197. Defendants abused the control repositied in them by virtue of their high-level positions  
2 in the Company and were aided and abetted by each other.

3 198. By reason of the foregoing conduct, defendants have damaged F5.

4 199. Plaintiffs, as shareholders of F5, seek damages and other relief for F5.

5 **COUNT VI**

6 **(Against All Defendants for Corporate Waste)**

7 200. Plaintiffs incorporate ¶¶1-177.

8 201. As a result of defendants' misconduct and waste of corporate assets F5 has sustained  
9 damage.

10 202. Plaintiffs, as shareholders of F5, seek damages and other relief for F5.

11 **COUNT VII**

12 **(Against All Defendants for Gross Mismanagement)**

13 203. Plaintiffs incorporate ¶¶1-177.

14 204. Defendants have grossly mismanaged F5. They have also failed to exercise  
15 independent or good faith oversight of F5 or its executives, and thus have permitted that gross  
16 mismanagement.

17 205. By their actions, defendants breached their duties to oversee, direct and control F5 in  
18 a manner consistent with the legal duties of directors and officers of a publicly held company and  
19 under the applicable state law.

20 206. Plaintiffs, as shareholders of F5, seek damages and other relief for F5.

21 **COUNT VIII**

22 **(Against All Defendants for Unjust Enrichment)**

23 207. Plaintiffs incorporate ¶¶1-177.

24 208. As a result of the unlawful conduct detailed above, defendants have been or will be  
25 unjustly enriched at the expense of F5. In particular, defendants will be unjustly enriched to the  
26 extent they have and/or will continue to receive excessive compensation, stock option and/or insider

1 trading proceeds despite their breaches of fiduciary duty, gross mismanagement, abuse of control  
2 and other misconduct detailed herein.

3 209. Defendants should be required to disgorge the gain which they unjustly obtained at  
4 the expense of F5.

5 210. As a result of the defendants' misconduct and unjust enrichment, F5 has sustained  
6 damage.

7 211. Plaintiffs, as shareholders of F5, seek damages and other relief for F5.

### 8 **COUNT IX**

#### 9 **(Against All Defendants for Abuse of Control)**

10 212. Plaintiffs incorporate ¶¶1-177.

11 213. Defendants, together with their corporate allies, own and/or control F5 and have the  
12 power to dictate the outcome of F5's business and affairs. As persons with the power to direct F5's  
13 business and affairs, defendants owed F5 a fiduciary duty to act in the best interest of the Company  
14 and not for their own personal profit or gain.

15 214. Nevertheless, over the past decade, defendants have abused their control by engaging  
16 in a secret stock option backdating scheme, and grossly mismanaging F5's business so badly that  
17 F5's market capitalization has collapsed and its goodwill and reputation have been ruined.  
18 Defendants also deliberately and/or recklessly refused to exercise independent and good faith  
19 oversight of F5 and its executives, and therefore deliberately allowed the abuse of control  
20 complained of herein to occur.

21 215. This conduct by defendants amounted to an abuse of their abilities to act in the best  
22 interest of F5 in violation of their fiduciary obligations as controlling persons, directors and/or  
23 officers of F5.

24 216. As a result of defendants' misconduct, F5 has sustained damage.

25 217. Plaintiffs, as shareholders of F5, seek damages and other relief for F5.

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**COUNT X**

**(Against Defendants McAdam, Higginson, Grinstein, Guelich, Ames, Reinland, Reiter, Rodriguez, Amdahl, Coburn, Eames, Goldman, Hussey and Pancottine, for Insider Selling and Misappropriation of Information)**

218. Plaintiffs incorporate ¶¶1-177.

219. At the time of their stock sales, defendants McAdam, Higginson, Grinstein, Guelich, Ames, Reinland, Reiter, Rodriguez, Amdahl, Coburn, Eames, Goldman, Helsel, Hussey and Pancottine knew that the Company's financial results were false and misleading. These defendants' sales of F5 common stock while in possession and control of this material adverse non-public information was a breach of their fiduciary duties of good faith, honesty and loyalty.

220. Since the use of the Company's proprietary information for their own gain constitutes a breach of the fiduciary owed by defendants McAdam, Higginson, Grinstein, Guelich, Ames, Reinland, Reiter, Rodriguez, Amdahl, Coburn, Eames, Goldman, Helsel, Hussey and Pancottine to F5, plaintiffs, on behalf of the Company, are entitled to the imposition of a trust on any profits defendants McAdam, Higginson, Grinstein, Guelich, Ames, Reinland, Reiter, Rodriguez, Amdahl, Coburn, Eames, Goldman, Helsel, Hussey and Pancottine obtained thereby.

221. Plaintiffs, as shareholders of F5, seek damages and other relief for F5.

**COUNT XI**

**(Against All Defendants for Rescission)**

222. Plaintiffs incorporate ¶¶1-177.

223. As a result of the acts alleged herein, the stock option contracts defendants and F5 entered into during the relevant period were obtained through defendants' breaches of fiduciary duty, gross mismanagement and abuse of control. Further, the backdated stock options were illegal grants and thus invalid as they were not authorized in accordance with the terms of F5's stock option plans which were also approved by its shareholders and filed with the SEC.

224. All contracts which provide for stock option grants between defendants and F5 that were entered into during the relevant period should, therefore, be rescinded, with all sums paid under

1 such contracts returned to the Company, and all such executory contracts cancelled and declared  
2 void.

3 225. Plaintiffs, as shareholders of F5, seek damages and other relief for F5.

4 **COUNT XII**

5 **(Against All Defendants for an Accounting)**

6 226. Plaintiffs incorporate ¶¶1-177.

7 227. At all relevant times, defendants, as directors and/or officers of F5, owed the  
8 Company fiduciary duties, including good faith, honesty and loyalty.

9 228. In breach of their fiduciary duties owed to F5, defendants caused F5, among other  
10 things, to grant backdated stock options to themselves and/or certain other officers and directors of  
11 F5. By this wrongdoing, defendants breached their fiduciary duties owed to F5.

12 229. Defendants possess complete and unfettered control over their improperly issued  
13 stock option grants and the books and records of the Company concerning the details of such  
14 improperly backdated stock option grants to F5 executives and employees.

15 230. As a result of defendants' misconduct, F5 has been substantially injured and damaged  
16 financially and is entitled to a recovery as a result thereof, including the proceeds of those  
17 improperly granted options which have been exercised and sold.

18 231. Plaintiffs demand an accounting be made of all stock options grants made to  
19 defendants, including, without limitation, the dates of the grants, the amounts of the grants, the value  
20 of the grants, the recipients of the grants, the exercise date of stock options granted to defendants, as  
21 well as the disposition of any proceeds received by defendants via sale or other exercise of  
22 backdated stock option grants received by the defendants.

23 232. Plaintiffs, as shareholders of F5, seek damages and other relief for F5.

24 **PRAYER FOR RELIEF**

25 WHEREFORE, plaintiffs demand judgment as follows:  
26

1           A.     Awarding money damages against all defendants, jointly and severally, for all losses  
2 and damages suffered as a result of the acts and transactions complained of herein, together with pre-  
3 judgment interest, to ensure defendants do not participate therein or benefit thereby;

4           B.     Directing all defendants to account for all damages caused by them and all profits and  
5 special benefits and unjust enrichment they have obtained as a result of their unlawful conduct,  
6 including all salaries, bonuses, fees, stock awards, options and common stock sale proceeds and  
7 imposing a constructive trust thereon;

8           C.     Directing F5 to take all necessary actions to reform and improve its corporate  
9 governance and internal control procedures to comply with applicable law, including, but not limited  
10 to, putting forward for a shareholder vote resolutions for amendments to the Company's By-Laws or  
11 Articles of Incorporation and taking such other action as may be necessary to place before  
12 shareholders for a vote adoption of the following Corporate Governance policies:

13               (i)     a proposal requiring that the office of CEO of F5 and Chairman of the F5  
14 Board of Directors be permanently held by separate individuals and that the Chairman of the F5  
15 Board meets rigorous "independent" standards;

16               (ii)    a proposal to strengthen the F5 Board of Directors' supervision of operations  
17 and develop and implement procedures for greater shareholder input into the policies and guidelines  
18 of the Board;

19               (iii)   appropriately test and then strengthen the internal audit and control functions;

20               (iv)    rotate independent auditing firms every five years;

21               (v)     control and limit insider stock selling and the terms and timing of stock option  
22 grants; and

23               (vi)    reform executive compensation;

24           D.     Ordering the imposition of a constructive trust over defendants' stock options and any  
25 proceeds derived therefrom;

26           E.     Awarding punitive damages;

1 F. Awarding costs and disbursements of this action, including reasonable attorneys',  
2 accountants', and experts' fees; and

3 G. Granting such other and further relief as this Court may deem just and proper.

4 **JURY DEMAND**

5 Plaintiffs demand a trial by jury.

6 DATED: September 14, 2007

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AMENDED CONSOLIDATED VERIFIED  
SHAREHOLDERS DERIVATIVE COMPLAINT  
(C-06-0794-RSL)

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**VERIFICATION**

I, BENNY C. GOODMAN III, hereby declare as follows:

1. I am a member of the law firm of Coughlin Stoia Geller Rudman & Robbins LLP, Lead Counsel for plaintiffs in the above-entitled action. I have read the foregoing Amended Consolidated Verified Shareholders Derivative Complaint and know the contents thereof. I am informed and believe the matters therein are true and on that ground allege that the matters stated therein are true.

Executed this 14th day of September, 2007, at San Diego, California.

  
BENNY C. GOODMAN III

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I certify under penalty of perjury under the laws of the United States of America that the foregoing is true and correct. Executed on September 14, 2007.

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- (No manual recipients)

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## THE WALL STREET JOURNAL.

The Wall Street Journal

March 18, 2006 Saturday

**SECTION:** Pg. A1

**LENGTH:** 4228 words

**HEADLINE:** The Perfect Payday --- Some CEOs reap millions by landing stock options when they are most valuable; Luck -- or something else?

**BYLINE:** By Charles Forelle and James Bandler

**BODY:**

ON A SUMMER DAY IN 2002, shares of Affiliated Computer Services Inc. sank to their lowest level in a year. Oddly, that was good news for Chief Executive Jeffrey Rich.

His annual grant of stock options was dated that day, entitling him to buy stock at that price for years. Had they been dated a week later, when the stock was 27% higher, they'd have been far less rewarding. It was the same through much of Mr. Rich's tenure: In a striking pattern, all six of his stock-option grants from 1995 to 2002 were dated just before a rise in the stock price, often at the bottom of a steep drop.

Just lucky? A Wall Street Journal analysis suggests the odds of this happening by chance are extraordinarily remote -- around one in 300 billion. The odds of winning the multistate Powerball lottery with a \$1 ticket are one in 146 million.

Suspecting such patterns aren't due to chance, the Securities and Exchange Commission is examining whether some option grants carry favorable grant dates for a different reason: They were backdated. The SEC is understood to be looking at about a dozen companies' option grants with this in mind.

The Journal's analysis of grant dates and stock movements suggests the problem may be broader. It identified several companies with wildly improbable option-grant patterns. While this doesn't prove chicanery, it shows something very odd: Year after year, some companies' top executives received options on unusually propitious dates. (An explanation of the methodology is below.)

The analysis bolsters recent academic work suggesting that backdating was widespread, particularly from the start of the tech-stock boom in the 1990s through the Sarbanes-Oxley corporate reform act of 2002. If so, it was another way some executives enriched themselves during the boom at shareholders' expense. And because options grants are

## The Perfect Payday --- Some CEOs reap millions by landing stock options

long-lived, some executives holding backdated grants from the late 1990s could still profit from them today.

Mr. Rich called his repeated favorable option-grant dates at ACS "blind luck." He said there was no backdating, a practice he termed "absolutely wrong." A spokeswoman for ACS, Lesley Pool, disputed the Journal's analysis of the likelihood of Mr. Rich's grants all falling on such favorable dates. But Ms. Pool added that the timing wasn't purely happenstance: "We did grant options when there was a natural dip in the stock price," she said. On March 6, ACS said that the SEC is examining its option grants.

Stock options give recipients a right to buy company stock at a set price, called the exercise price or strike price. The right usually doesn't vest for a year or more, but then it continues for several years. The exercise price is usually the stock's 4 p.m. price on the date of the grant, an average of the day's high and low, or the 4 p.m. price the day before. Naturally, the lower it is, the more money the recipient can potentially make someday by exercising the options.

Which day's price the options carry makes a big difference. Suppose an executive gets 100,000 options on a day when the stock is at \$30. Exercising them after it has reached \$50 would bring a profit of \$20 times 100,000, or \$2 million. But if the grant date was a month earlier and the stock then was at, say, \$20, the options would bring in an extra \$1 million.

A key purpose of stock options is to give recipients an incentive to improve their employer's performance, including its stock price. No stock gain, no profit on the options. Backdating them so they carry a lower price would run counter to this goal, by giving the recipient a paper gain right from the start.

Companies have a right to give executives lavish compensation if they choose to, but they can't mislead shareholders about it. Granting an option at a price below the current market value, while not illegal in itself, could result in false disclosure. That's because companies grant their options under a shareholder-approved "option plan" on file with the SEC. The plans typically say options will carry the stock price of the day the company awards them or the day before. If it turns out they carry some other price, the company could be in violation of its options plan, and potentially vulnerable to an allegation of securities fraud.

It could even face accounting issues. Options priced below the stock's fair market value when they're awarded bring the recipient an instant paper gain. Under accounting rules, that's equivalent to extra pay and thus is a cost to the company. A company that failed to include such a cost in its books may have overstated its profits, and might need to restate past financial results.

The Journal's analysis raises questions about one of the most lucrative stock-option grants ever. On Oct. 13, 1999, William W. McGuire, CEO of giant insurer UnitedHealth Group Inc., got an enormous grant in three parts that -- after adjustment for later stock splits -- came to 14.6 million options. So far, he has exercised about 5% of them, for a profit of about \$39 million. As of late February he had 13.87 million unexercised options left from the October 1999 tranche. His profit on those, if he exercised them today, would be about \$717 million more.

The 1999 grant was dated the very day UnitedHealth stock hit its low for the year. Grants to Dr. McGuire in 1997 and 2000 were also dated on the day with those years' single lowest closing price. A grant in 2001 came near the bottom of a sharp stock dip. In all, the odds of such a favorable pattern occurring by chance would be one in 200 million or greater. Odds such as those are "astronomical," said David Yermack, an associate professor of finance at New York University, who reviewed the Journal's methodology and has studied options-timing issues.

Options grants are made by directors, with details often handled by a compensation committee. Many companies make their grants at the same time each year, a policy that limits the potential for date fudging. But no law requires this.

Until last year, UnitedHealth had a very unusual policy: It let Dr. McGuire choose the day of his own option grants. According to his 1999 employment agreement, he is supposed to choose dates by giving "oral notification" to the chairman of the company's compensation committee. The agreement says the exercise price shall be the stock's closing

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price on the date the grants are issued.

Arthur Meyers, an executive-compensation attorney with Seyfarth Shaw LLP in Boston, said a contract such as that sounded "like a thinly disguised attempt to pick the lowest grant price possible." Mr. Meyers said such a pact could pose several legal issues, possibly violating Internal Revenue Service and stock-exchange listing rules that require directors to set a CEO's compensation. "If he picks the date of his grant, he has arguably set a portion of his pay. It's just not good corporate governance."

UnitedHealth called the process by which its grants were awarded "appropriate." It declined to answer specific questions about grant dates but noted that on all but two of them, grants were made to a broad group of employees.

William Spears, a member of UnitedHealth's compensation committee, said the October 1999 grant wasn't backdated but was awarded concurrently with the signing of Dr. McGuire's employment contract. Mr. Spears said a depressed stock price spurred directors to wrap up negotiations and get options to management. The board revised terms of the employment contract last year and will start making stock-option grants at a regular time each year, Mr. Spears added.

The SEC's look at options timing was largely prompted by academic research that examined thousands of companies and found odd patterns of stock movement around the dates of grants. One study was by Erik Lie of the University of Iowa. He found that share prices generally fell before option grants and rose afterward, with the result that recipients got options at favorable times. He concluded this was so unlikely to happen by chance that at least some grant dates had to have been filled in retroactively.

Another possible explanation for big rises in stock prices following grants is that executives knew favorable company news was coming and timed the grants just before it. But academics think timing for company news is a less likely explanation for the patterns, given the consistency of the stock climbs after grant dates. Also, for many of the companies the Journal examined, no obvious company news followed closely upon the option grants.

It's also possible companies sometimes award options after their stock has taken a fall and seems to them to be undervalued. In point of fact, the companies can't possibly know what the stock will do next, but that doesn't mean they might not feel confident enough about a recovery to think they are hitting a favorable time to grant options.

The use of stock options surged in the late 1990s as young firms that had bright prospects but little revenue used them to attract and pay executives. As dot-com and telecom shares exploded, stock options became a source of vast wealth.

They also grew controversial. Critics worried that big options grants tempted executives to do whatever it took to get the stock price up, at least long enough to cash in their options. At the same time, during a general bull market, the options sometimes richly rewarded executives for stock buoyancy that had little to do with their own efforts.

At Mercury Interactive Corp., a Mountain View, Calif., software maker, the chief executive and two others resigned late last year. Mercury said an internal probe found 49 cases where the reported date of options grants differed from the date when the options appeared to have been awarded. The company said it will have to restate financial results. The SEC is still looking at Mercury, said someone familiar with the situation.

Analog Devices Inc. says it reached a tentative settlement with the SEC last fall. It neither admitted nor denied that it had misdated options or had made grants just before releasing good news that would tend to push up the stock. The Norwood, Mass., computer-chip maker tentatively agreed to pay a \$3 million civil penalty and re-price some options. CEO Jerald Fishman tentatively agreed to pay a \$1 million penalty and disgorge some profits. Analog didn't make him available for comment. The company said it will not restate its financial records.

In some instances, backdating wouldn't be possible without inattentive directors, securities lawyers say. At one



## The Perfect Payday --- Some CEOs reap millions by landing stock options

company the SEC is looking at, lawyers say, it appears that someone picked a favorable past date for an option grant and gave it to directors for retroactive approval, perhaps counting on them not to notice. In another case, the lawyers say, a space for the grant date appears to have been left blank on paperwork approved by directors, or dates were later altered.

Until 2002, companies didn't have to report option grants until months later. The Sarbanes-Oxley law, by forcing them to report grants within two days, left less leeway to retroactively date a grant.

The new rule reduced stock patterns suggestive of backdating, but didn't eliminate these altogether, according to a study by M.P. Narayanan and H. Nejat Seyhun of the University of Michigan. They found that companies report about a quarter of option grants later than the two-day deadline -- and that such delayed reporting is associated with big price gains after the grant dates. It is a pattern Mr. Narayanan calls "consistent with backdating."

Before the stricter rules, Brooks Automation Inc., a semiconductor-equipment maker in Chelmsford, Mass., gave 233,000 options to its CEO, Robert Therrien, in 2000. The stated grant date was May 31. That was a great day to have options priced. Brooks's stock plunged over 20% that day, to \$39.75. And the very next day it surged more than 30%.

A June 7 Brooks report to the SEC covering Mr. Therrien's May options activity made no mention of his having gotten a grant on May 31, even though the report -- which Mr. Therrien signed -- did cite other options-related actions he took on May 31. Not until August was the May 31 grant reported to the SEC.

It wasn't the only well-timed option grant he got. One in October 2001 came at Brooks stock's lowest closing price that year, once again at the nadir of a sharp plunge. The Journal analysis puts the odds of such a consistent pattern occurring by chance at about 1 in nine million.

Mr. Therrien, who stepped down as CEO in 2004 and retired as chairman this month, didn't return messages seeking comment. Chief Financial Officer Robert Woodbury said Brooks is "in the process of revamping" practices so grants come at about the same time each year. Mr. Woodbury, who joined in 2003, said no one at Brooks would be able to explain the timing of Mr. Therrien's grants.

The highly favorable 2000 grant also benefited two others at Brooks -- the compensation-committee members who oversaw the CEO's grants. Although Brooks directors typically got options only in July, that year a special grant was awarded just to these two directors, Roger Emerick and Amin J. Khoury. Each got 20,000 options at the low \$39.75 price. By the time of their regular July option-grant date, the stock was way up to \$61.75, a price far less favorable to options recipients.

Mr. Emerick, a retired CEO of Lam Research Corp., declined to be interviewed. Mr. Khoury, the CEO of BE Aerospace Inc. in Wellington, Fla., didn't return messages left at his office.

Another company, Comverse Technology Inc., said Tuesday that its board had started a review of its past stock-option practices, including "the accuracy of the stated dates of options grants," following questions about the dates from the Journal. The announcement reversed a prior Comverse statement -- given a week earlier in response to Journal inquiries -- saying all grants were made in accordance with applicable laws and regulations.

The Journal's analysis spotlighted an unusual pattern of grants to Kobi Alexander, chief executive of the New York maker of telecom systems and software. One grant was dated July 15, 1996, and carried an exercise price of \$7.9167, adjusted for stock splits. It was priced at the bottom of a sharp one-day drop in the stock, which fell 13% the day of the grant and then rebounded 13% the next day.

Another grant, on Oct. 22, 2001, caught the second-lowest closing price of 2001. Others also corresponded to price dips. The odds of such a pattern occurring by chance are around 1 in six billion, according to the Journal's analysis.

## The Perfect Payday --- Some CEOs reap millions by landing stock options

Before Comverse announced its internal probe, John Friedman, a member of the board's compensation committee, said directors had noticed the scattered nature of the grants -- eight between 1994 and 2001 fell in six different months -- but management assured them there were valid reasons. Mr. Alexander, the CEO, didn't return phone calls.

This week, Comverse said that, as a result of the board's review of its options grants, it expects it will need to restate past financial results.

Propitious option timing can help build fortunes even at companies where the stock doesn't steadily rise. Shares of Vitesse Semiconductor Corp., although they zoomed in the late 1990s, now rest at about the level of a decade ago. But Louis R. Tomasetta, chief executive of the Camarillo, Calif., chip maker, reaped tens of millions of dollars from stock options.

Mr. Tomasetta got a grant in March 1997 that, adjusted for later stock splits, gave him the right to buy 600,000 shares at \$5.625 each. The date they were priced coincided with a steep fall in Vitesse's stock, to what turned out to be its low for the year. He pocketed \$23.1 million in profit when he exercised most of these options between 1998 and 2001. Had the grant come 10 days earlier, when the stock price was much stronger, he would have made \$1.4 million less.

In eight of Mr. Tomasetta's nine option grants from 1994 to 2001, the grants were dated just before double-digit price surges in the next 20 trading days. The odds of such a pattern occurring by chance are about one in 26 billion.

Alex Daly, a member of the Vitesse board's compensation committee, said a review of the grants found "nothing extraordinary" about their timing, and "absolutely no grants have been made to anyone, least of all the CEO, that are out of sequence with our normal grant policy." Vitesse's finance chief, Yatin Mody, said the grants were "reviewed and approved" by the compensation committee, "and the exercise price set as of the date of the approval, as documented by the related minutes." He declined to provide a copy of those minutes. Mr. Tomasetta said the grants were "approved by the board and the price set at the close of the day of approval."

At ACS in Dallas, Mr. Rich helped turn a small technology firm into one with more than \$4.4 billion in annual revenue and about 55,000 employees. ACS handles paperwork, accounting and data for businesses and government agencies. It is a major outsourcer, relying on global labor. "It is a pretty boring business," Mr. Rich told the University of Michigan business school in 2004, "but there is a lot of money in boring."

While most of Mr. Rich's stock-option gains were due to rises in ACS stock, the exceptional timing of grants enhanced his take. If his grants from 1995 through 2002 had come at each year's average share price, rather than the favorable dates, he'd have made about 15% less.

An especially well-timed grant, in which Mr. Rich received 500,000 options at \$11.53, adjusted for stock splits, was dated Oct. 8, 1998. This happened to be the bottom of a steep plunge in the price. The shares fell 28% in the 20 trading days prior to Oct. 8, and rose 60% in the succeeding 20 trading days.

ACS's Ms. Pool said the grant was for Mr. Rich's promotion to CEO. He wasn't promoted until February 1999. Ms. Pool said there was a "six-month transition plan," and the Oct. 8 option grant was "in anticipation" of his promotion.

Mr. Rich would have fared far worse had his grant come on the day ACS announced his promotion. The stock by then was more than twice as high. The grant wasn't reported to the SEC until 10 months after the stated grant date. Ms. Pool said that was proper under regulations in place at the time.

A special board committee oversaw Mr. Rich's grants. Most years, its sole members were directors Frank Rossi and Joseph O'Neill. Mr. Rossi declined to comment. Mr. O'Neill said, "We had ups and downs in our stock price like any publicly traded stock. If there were perceived low points, would we grant options at that point? Yes."

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Mr. Rich said grants were made on the day the compensation committee authorized them, or within a day or so of that. He said he or Chairman Darwin Deason made recommendations to the special board committee about option dates.

Mr. Rich, who is 45 years old, resigned abruptly as ACS's chief executive on a Thursday in September to "pursue other business interests." Again, his timing was advantageous. In an unusual separation agreement, the company agreed to make a special payment of \$18.4 million, which was equal to the difference between the exercise price of 610,000 of his outstanding stock options and the closing ACS stock price on the day of his resignation.

But the company didn't announce the resignation that day. On the news the next Monday that its CEO was departing suddenly, the stock fell 6%. Mr. Rich netted an extra \$2 million by cashing in the options before the announcement, rather than on the day of it.

Mr. Rich said ACS signed his separation agreement on Friday, using Thursday's price for the options payout. He said it waited till Monday to release the news because it didn't want to seem "evasive" by putting the news out late Friday.

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George Anders contributed to this article.

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## How the Journal Analyzed Stock-Option Grants

The Wall Street Journal asked Erik Lie, an associate professor of finance at the University of Iowa who has studied backdating, to generate a list of companies that made stock-option grants that were followed by large gains in the stock price.

The Journal examined a number of the companies, looking at all of their option grants to their top executive from roughly 1995 through mid-2002. Securities-law changes in 2002 curtailed the potential for backdating a grant. Executives typically receive option grants annually.

Mr. Lie and other academics say a pattern of sharp stock appreciation after grant dates is an indication of backdating; by chance alone, grants ought to be followed by a mixed bag of stock performance -- some rises, some declines.

To quantify how unusual a particular pattern of grants is, the Journal calculated how much each company's stock rose in the 20 trading days following each grant date. The analysis then ranked that appreciation against the stock performance in the 20 days following all other trading days of the year. It ranked all 252 or so trading days in a given year according to how much the stock rose or fell following them.

For instance, Affiliated Computer Services Inc. reported an option grant to its then-president, Jeffrey Rich, dated Oct. 8, 1998. In the succeeding 20 trading days -- equal to roughly a month -- ACS stock rose 60.2%. That huge gain was the best 20-trading-day performance all year for ACS. So the Journal ranked Oct. 8 No. 1 for ACS for 1998.

It is very unlikely that several grants spread over a number of years would all fall on high-ranked days.

But all six of Mr. Rich's did. Another of his option grants also fell on the No. 1-ranked day of a year, March 9, 1995. Two grants fell on the second-ranked day, those in 1996 and 1997. In 2002, his options grant was on the third-ranked day of the year, and in 2000, his grant came on the fourth-ranked day.

If a year has 252 trading days, the probability of a single options grant coming on the top-ranked day of that year would be one in 252. The chance of it coming on a day ranked No. 8 or better would be eight in 252.

## The Perfect Payday --- Some CEOs reap millions by landing stock options

The analysis then used the probability of each grant to figure how likely it is that an executive's overall multiyear grant pattern, or one more extreme than the actual pattern, occurred merely by chance. The more high-ranked days in the pattern, the longer the odds and the more likely it is that some factor other than chance influenced those dates. Two companies said they did use something other than chance -- they made grants on days when they thought the stock was temporarily low. This could explain results that differ somewhat from chance, but it wouldn't account for the extreme patterns of consistent post-grant rises.

John Emerson, an assistant professor of statistics at Yale, reviewed the methodology and developed a computer program to calculate the probabilities for all of the executives' grants except those to UnitedHealth CEO William McGuire. Because the number of his grants and complexity of his pattern made a computational method infeasible, the Journal used an estimate for his probability that Mr. Emerson said is conservative. Mr. Emerson said the figures for all six executives surpass a standard threshold statisticians use to assess the significance of a result.

For Mr. Rich's grants, the Journal's methodology puts the overall odds of a chance occurrence at about one in 300 billion -- less likely than flipping a coin 38 times and having it come up "heads" every time.

Exceedingly long odds also turned up in the Journal's analysis of grant-date patterns at several other companies. "It's very, very, very unlikely that they could have produced such patterns just by choosing random dates," said Mr. Lie.

David Yermack, an associate professor of finance at New York University, reviewed the Journal's methodology and said it was a reasonable way to identify suspicious patterns of grants. But Mr. Yermack also said the odds shouldn't be thought of as precise figures, largely because they depend on assumptions in the method used to determine which grant dates are more favorable than others.

Because nobody actually authorizing the grant on a given day could have known how the stock would do in the future, the Journal's analysis used post-grant price surges as an indication of possible backdating. Academics theorize that the most effective way to consistently capture low-price days for option grants is to wait until after a stock has risen, then backdate a grant to a day prior to that rise.

The decision to look at 20 trading days after each grant was arbitrary. But Messrs. Yermack and Lie said it was a reasonable yardstick to detect possible backdating. Using a longer period, such as a year, wouldn't be a good way to spot backdating of a few days or weeks because the longer-term trading would overwhelm any backdating effect.

The 20-day price rises don't present an immediate opportunity to profit, since options can't usually be exercised until held a year or more. But when the options do become exercisable, they'll be more valuable if they were priced when the stock was low.

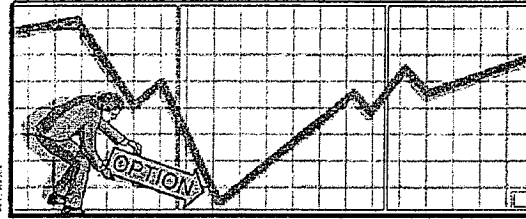
-- Charles Forelle

(See related letter: "Letters to the Editor: Certain Options Grants Don't Pass Smell Test" -- WSJ April 3, 2006)

## The Perfect Payday --- Some CEOs reap millions by landing stock options

## Buy Low

Certain executives have repeatedly received stock options on favorable dates—just ahead of sharp gains in the price of the company stock. Below, the number of option grants six executives received between roughly 1995 and 2002 and the odds—by a Wall Street Journal analysis—that such a favorable pattern of grants would occur by chance. Charts show three especially propitious grants to each executive, and what the stock did 2 months before the grant and what it did 2 months after.



Examples of options granted  
Stock prices adjusted for splits

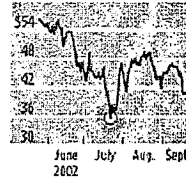
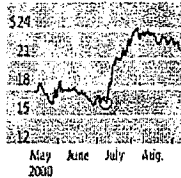
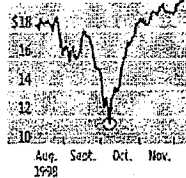
☉ Date of grant

Company's response

**Jeffrey Rich**  
Affiliated Computer  
Services, former chief  
executive

Total grants:  
6

Odds:  
About 1 in 300 billion

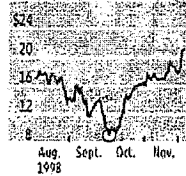
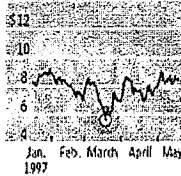
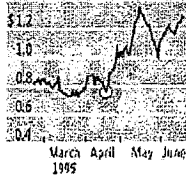


Mr. Rich said no grants were backdated, called his favorable dates "blind luck." Company spokeswoman said, "We did grant options when there was a natural dip in the stock price." Mr. Rich stepped down as chief executive last fall.

**Louis Tomasetta**  
Vitesse Semiconductor,  
president and chief  
executive

Total grants:  
9

Odds:  
About 1 in 26 billion

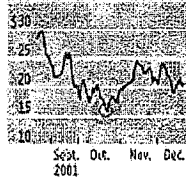
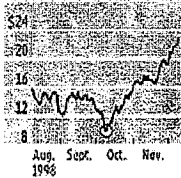
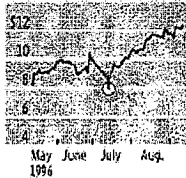


Mr. Tomasetta said the grants were "approved by the board" and the price set at the close of the day of approval. Alex Daly, a member of the board compensation committee, said there was "nothing extraordinary" about grant timing.

**Kobl Alexander**  
Comverse Technology,  
chairman and chief  
executive

Total grants:  
8

Odds:  
About 1 in 6 billion

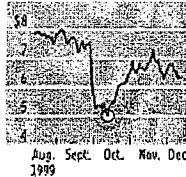
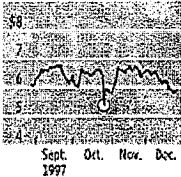
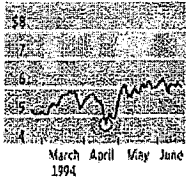


Company said its board has begun a review of past options practices, including "the accuracy of the stated dates of options grants." As a result, it expects to have to restate financial results.

**William McGuire**  
UnitedHealth Group,  
chairman and chief  
executive

Total grants:  
12

Odds:  
At least 1 in 200 million

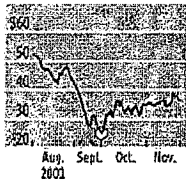
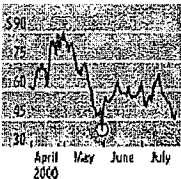
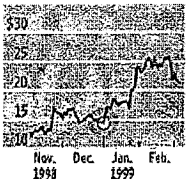


William Spears, a director, said the Oct. 13, 1999, grant was concurrent with signing of CEO's multiyear employment contract. "The price of the stock being at a depressed level gave us all an incentive to get options to management," wrapping up negotiations briskly.

**Robert Therrien**  
Brooks Automation,  
former chief executive

Total grants:  
7

Odds:  
About 1 in 9 million

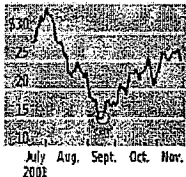
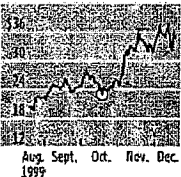
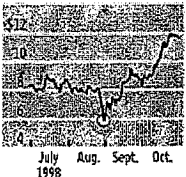


Company declined to explain grant timing. Finance chief Robert Woodbury said company is revamping policy to give options at same time each year. Mr. Therrien stepped down as CEO in 2004 and as chairman this month.

**Timothy Main<sup>2</sup>**  
Jabil Circuit, president  
and chief executive

Total grants:  
6

Odds:  
About 1 in 1 million



Company said it did not backdate grants or time them ahead of favorable news: "The scheduled meetings of the compensation committee and Board determined and dictated the date of grants, not the company's stock price."

<sup>1</sup>Some of the Brooks options in a 2000 grant were premium-priced and carried an exercise value above the market price. <sup>2</sup>Jabil's grants were priced at the previous day's close. The analysis used the date of the pricing.

Sources: WSJ Market Data Group; FactSet Research Systems; the companies; WSJ research; John Emerson of Yale University.

The Perfect Payday --- Some CEOs reap millions by landing stock options



Jeff Rich



William McGuire

NOTES:

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**Merrill Lynch**

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# Options Pricing - Hindsight is 20/20

## ■ We've conducted a detailed look at the history of options pricing for the components of the SOX

Practices surrounding the timing of options grants for public companies continue to come under scrutiny. We've conducted an analysis of the options grant timing for the semiconductor and semiconductor equipment companies that comprise the Philadelphia Semiconductor Index (SOX).

### The focus is on identifying excess returns subsequent to options pricing events

What we're interested in understanding is the extent to which stock price performance subsequent to options pricing events diverges from stock price performance over a longer period of time. That's the easiest and simplest way to measure how aggressive the timing of options grants has been. Theoretically, companies should not be generating any systematic excess return in comparison to other investors as a result of how options pricing events are timed.

### Excess returns are notable

The results are notable – for the 1997-2002 interval that we studied, the stocks comprising the SOX have consistently generated excess returns during the 20-day period following options grants. It is difficult to avoid concluding that the timing of options pricing for the period we studied has been very advantageous for executives that received options.

### Standout companies include KLAC, MRVL, NVLS, LLTC, BRCM, MXIM

A ranking of excess returns shows KLA Tencor, Marvell, Novellus, Linear Technology, Broadcom and Maxim Integrated Products at the top. We note that the excess returns calculation falls off sharply once one moves further down the list. Just for curiosity's sake we ran our analysis on Vitesse Semiconductor as well – Vitesse is already the subject of an SEC investigation related in part to the timing of options grants. The results place VTSS right at the top of the table, which tells us that we're capturing something meaningful with our analysis. We think that investors need to be aware of the possibility of regulatory activity at other companies that turn up high on our ranking.

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Refer to important disclosures on page 24 to 25. Analyst Certification on page 23. Price Objective Basis/Risk on page 22.

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### **We looked at the timing of options pricing for the components of the Philadelphia Semiconductor Index for 1997-2002**

Practices surrounding the timing of options grants for public companies continue to come under scrutiny. We've conducted an analysis of the options grant timing for the semiconductor and semiconductor equipment companies that comprise the Philadelphia Semiconductor Index (SOX). Our analysis covered the 1997-2002 period – the implementation of Sarbanes Oxley reporting requirements following 2002 renders the analysis less valuable.

### **Most of the information is available in public filings**

Our methodology is straightforward. Publicly available proxy statements report the number of options granted and the price of the underlying equity at the time of the grant. Grant dates are usually stated explicitly, and when they're not we are able to derive the grant date based on the stated expiration date and the lifetime of the option. We're also able to use the stated grant price as an additional check, being as qualified options are granted at the trading price of a stock.

### **Analysis focuses on divergence between overall returns and returns during the interval following an options pricing event**

What we're interested in understanding is the extent to which stock price performance subsequent to options pricing diverges from stock price performance over a longer period of time. That's the easiest and simplest way to measure how aggressive the timing of options grants has been. Specifically, we've looked at annualized stock price returns for the 20 day period subsequent to options pricing in comparison to stock price returns for the calendar year in which the options were granted.

### **We don't think there should be any systematic excess returns if the options pricing process isn't being timed**

Theoretically, if the timing of options grants is an arm's length process, and companies haven't systematically taken advantage of their ability to backdate options within the 20-day windows that the law provided prior to the implementation of Sarbanes Oxley in 2002, there shouldn't be any difference between the two measures. The extent to which the two measures diverge forms the basis for our evaluation of the aggressiveness of each company's options pricing policies.

### **In fact, returns following options pricing events are notable**

The results are notable – for the 1997-2002 interval that we studied, the stocks comprising the SOX have consistently generated excess returns during the 20-day period following options grants. The average annualized excess return for the 20 day period over calendar year returns is 204% for our universe of stocks. Regardless of whether the excess returns result from backdating or not, managements for our universe of companies seem remarkably effective at timing options pricing events. We want to emphasize that we're not taking any position in this report on whether companies have actually backdated options or not – the records that we have access to aren't sufficiently detailed to reach that judgment.



### Standout companies include KLAC, MRVL, NVLS, LLTC, BRCM, MXIM

A ranking of excess returns shows KLA Tencor, Marvell, Novellus, Linear Technology, Broadcom and Maxim Integrated Products at the top. We note that the excess returns calculation falls off sharply once one moves further down the list. Just for curiosity's sake we ran our analysis on Vitesse Semiconductor as well. Vitesse is already the subject of an SEC investigation related in part to the timing of options grants. The results place VTSS right at the top of the table – it appears that we've captured something meaningful with our approach. We think that investors need to be aware the possibility of regulatory activity at other companies that turn up high on our ranking.

*We note that our methodology is similar to that used by the Center for Financial Research and Analysis in a recently published report. However, we've looked at a different sample of companies over a longer time period, and used different criteria for ranking options pricing behavior.*

**Table 1: Philadelphia Semiconductor Index Components Ranked by Excess Option Pricing Returns**

Company	Rank
Vitesse*	1
KLA Tencor	2
Marvell	3
Novellus	4
Linear	5
Broadcom	6
Maxim	7
Teradyne	8
Xilinx	9
Applied Materials	10
AMD	11
Altera	12
Texas Instruments	13
National	14
Intel	15
Micron	16

Source: Merrill Lynch

\* VTSS is not a component of the SOX, but has been included for comparative purposes

Table 2: Management 20-Day Return\*

SOX Components	1997	1998	1999	2000	2001	2002 Average	Rank	
Altera	-1%	19%	16%	22%	-6%	-11%	6%	12
Applied Materials	NA	25%	0%	-2%	16%	-3%	7%	10
AMD	13%	-2%	16%	-7%	20%	0%	7%	11
Broadcom	NA	11%	NA	39%	14%	4%	17%	6
Intel	2%	10%	0%	-5%	27%	-16%	3%	15
KLA Tencor	13%	14%	160%	23%	51%	5%	44%	2
Linear	NA	28%	-1%	39%	21%	29%	23%	5
Marvell	NA	NA	NA	NA	57%	14%	36%	3
Maxim	13%	27%	26%	0%	11%	4%	14%	7
Micron	-25%	0%	-20%	-41%	-6%	-32%	-21%	16
National	10%	-15%	31%	4%	-9%	-2%	3%	14
Novellus	19%	31%	61%	28%	2%	1%	24%	4
Teradyne	0%	-5%	45%	19%	8%	-15%	8%	8
Texas Instruments	14%	22%	-9%	23%	-18%	5%	6%	13
Xilinx	-9%	19%	14%	-8%	24%	4%	7%	9
Other Companies								
Vitesse	35%	46%	39%	NA	68%	116%	61%	1

Source: Merrill Lynch

\*Average stock return for the 20 days following any options pricing event for senior executives as reported in proxy filings

Table 3: Management Annualized Return\*

SOX Components	1997	1998	1999	2000	2001	2002 Average	Rank	
Altera	-19%	336%	292%	389%	-102%	-204%	115%	12
Applied Materials	NA	448%	0%	-44%	290%	-60%	127%	10
AMD	228%	-36%	295%	-133%	366%	-6%	119%	11
Broadcom	NA	193%	NA	710%	255%	64%	305%	6
Intel	43%	177%	5%	-95%	481%	-289%	54%	15
KLA Tencor	235%	252%	2886%	415%	920%	95%	800%	2
Linear	NA	497%	-17%	695%	375%	528%	416%	5
Marvell	NA	NA	NA	NA	1020%	260%	640%	3
Maxim	236%	487%	473%	-5%	193%	75%	243%	7
Micron	-443%	0%	-366%	-743%	-116%	-569%	-373%	16
National	178%	-269%	557%	67%	-156%	-45%	55%	14
Novellus	333%	566%	1098%	506%	30%	17%	425%	4
Teradyne	-6%	-92%	802%	340%	149%	-277%	153%	8
Texas Instruments	246%	394%	-155%	420%	-327%	90%	111%	13
Xilinx	-158%	338%	248%	-139%	427%	74%	132%	9
Other Companies								
Vitesse	621%	833%	711%	NA	1231%	2082%	1096%	1

Source: Merrill Lynch

\* Annualized returns for the 20-day stock return data reported in Table 2

Table 4: Investor Annualized Return\*

SOX Components	1997	1998	1999	2000	2001	2002 Average	Rank
Altera	-8%	84%	63%	6%	-19%	-42%	12
Applied Materials	0%	38%	186%	-40%	2%	-37%	8
AMD	-35%	63%	0%	-5%	15%	-59%	15
Broadcom	NA	125%	351%	-38%	-51%	-63%	1
Intel	8%	69%	39%	-27%	5%	-50%	14
KLA Tencor	13%	7%	143%	-38%	45%	-32%	9
Linear	37%	57%	61%	30%	-15%	-34%	10
Marvell	NA	NA	NA	-62%	68%	-49%	16
Maxim	55%	27%	116%	1%	10%	-37%	4
Micron	-13%	95%	55%	-9%	-13%	-69%	13
National	9%	-48%	217%	-53%	53%	-51%	11
Novellus	16%	46%	136%	-13%	12%	-33%	5
Teradyne	33%	26%	213%	-40%	-20%	-58%	7
Texas Instruments	44%	92%	127%	-2%	-41%	-46%	3
Xilinx	-3%	86%	179%	1%	-15%	-47%	2
<b>Other Companies</b>							
Vitesse	36%	142%	130%	6%	-76%	-82%	6

Source: Merrill Lynch

\* Calendar year annual returns

Table 5: Management Excess Return\*

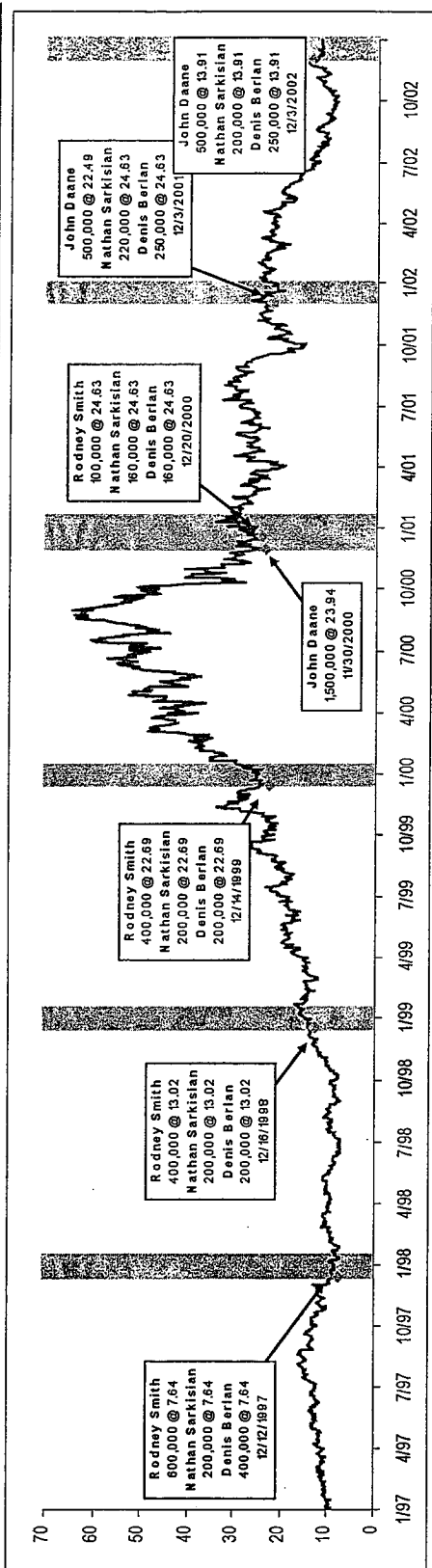
SOX Components	1997	1998	1999	2000	2001	2002 Average	Rank
Altera	-11%	252%	230%	383%	-82%	-163%	10
Applied Materials	NA	410%	-186%	-4%	288%	-22%	12
AMD	262%	-99%	295%	-129%	351%	54%	9
Broadcom	NA	68%	NA	748%	306%	127%	6
Intel	35%	108%	-34%	-68%	476%	-239%	14
KLA Tencor	222%	245%	2742%	453%	874%	127%	2
Linear	NA	440%	-78%	665%	390%	562%	5
Marvell	NA	NA	NA	NA	953%	309%	3
Maxim	181%	460%	357%	-7%	183%	113%	7
Micron	-430%	-95%	-420%	-734%	-103%	-500%	16
National	169%	-221%	340%	120%	-209%	6%	15
Novellus	317%	520%	963%	518%	18%	49%	4
Teradyne	-39%	-118%	589%	380%	168%	-219%	8
Texas Instruments	202%	302%	-282%	422%	-286%	137%	13
Xilinx	-155%	252%	69%	-141%	442%	121%	11
<b>Other Companies</b>							
Vitesse	585%	691%	581%	NA	1307%	2164%	1

Source: Merrill Lynch

\* Excess of annualized management return reported in Table 3 over investor annual return reported in Table 4

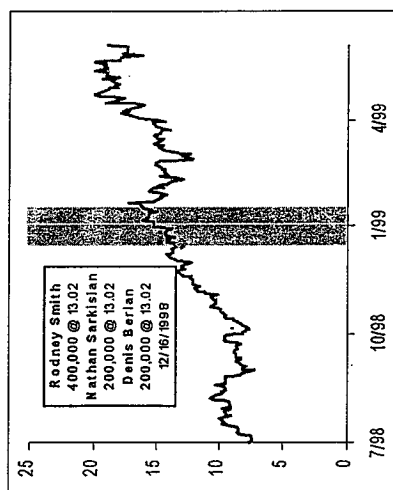
# Altera (ALTR; US\$18.73; C-1-9)

Chart 1: ALTR C-Level Stock Grants 1997-2002



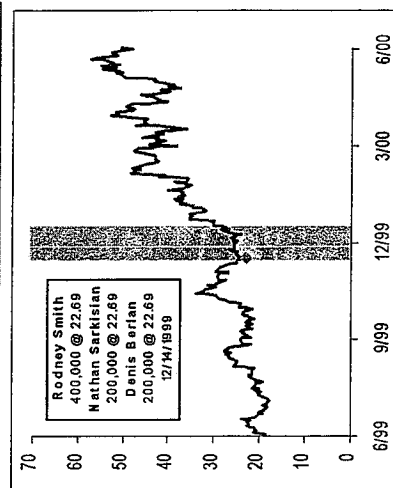
Source: Company Reports, Merrill Lynch

Chart 2: ALTR 1998 Detail



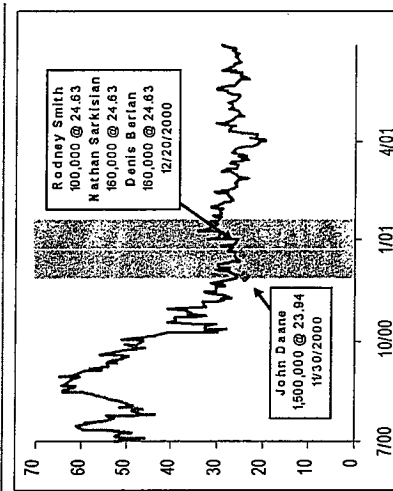
Source: Company Reports, Merrill Lynch

Chart 3: ALTR 1999 Detail



Source: Company Reports, Merrill Lynch

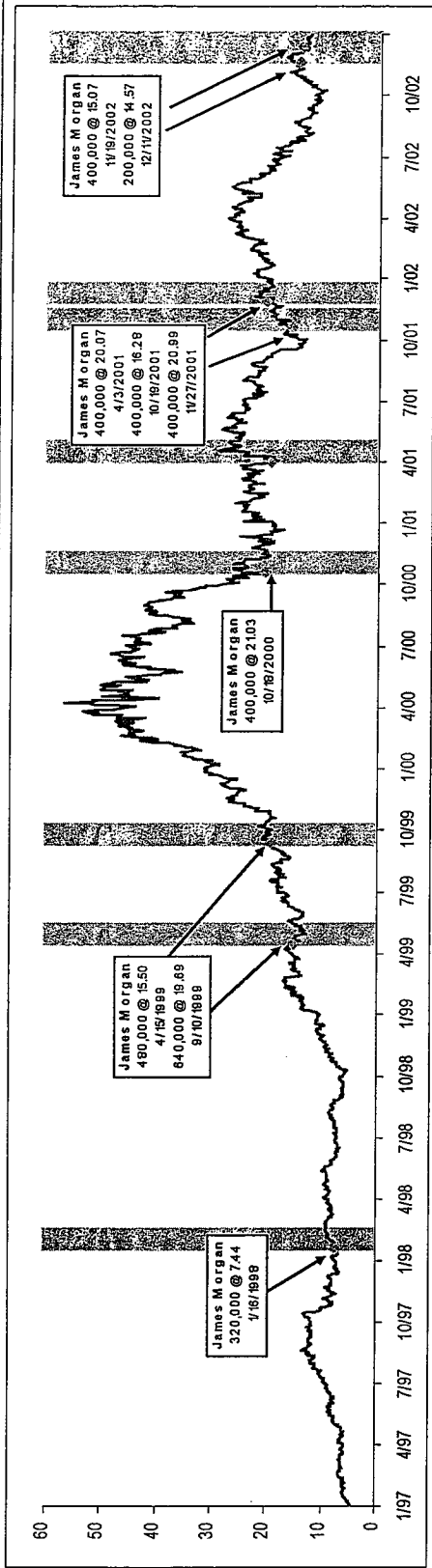
Chart 4: ALTR 2000 Detail



Source: Company Reports, Merrill Lynch

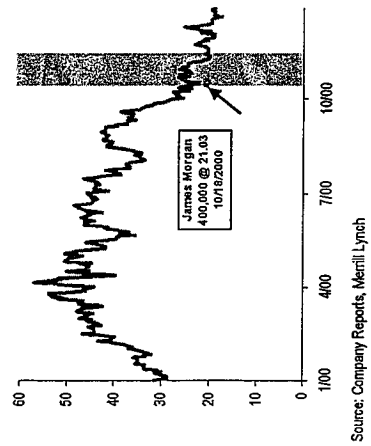
# Applied Materials (AMAT; US\$17.00; C-2-7)

Chart 5: AMAT C-Level Stock Grants 1997-2002



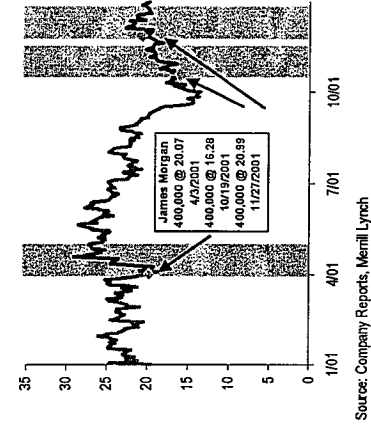
Source: Company Reports, Merrill Lynch

Chart 6: AMAT 2000 Detail



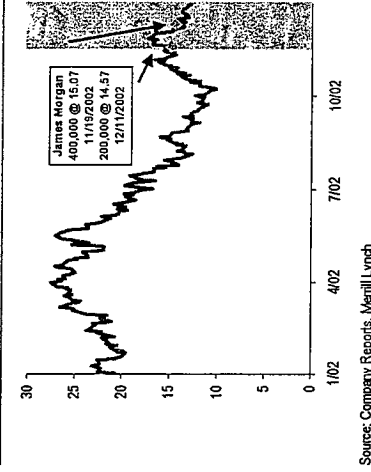
Source: Company Reports, Merrill Lynch

Chart 7: AMAT 2001 Detail



Source: Company Reports, Merrill Lynch

Chart 8: AMAT 2002 Detail



Source: Company Reports, Merrill Lynch

# Advanced Micro Devices (AMD; US\$34.95; C-3-9)

Chart 9: AMD C-Level Stock Grants 1997-2002

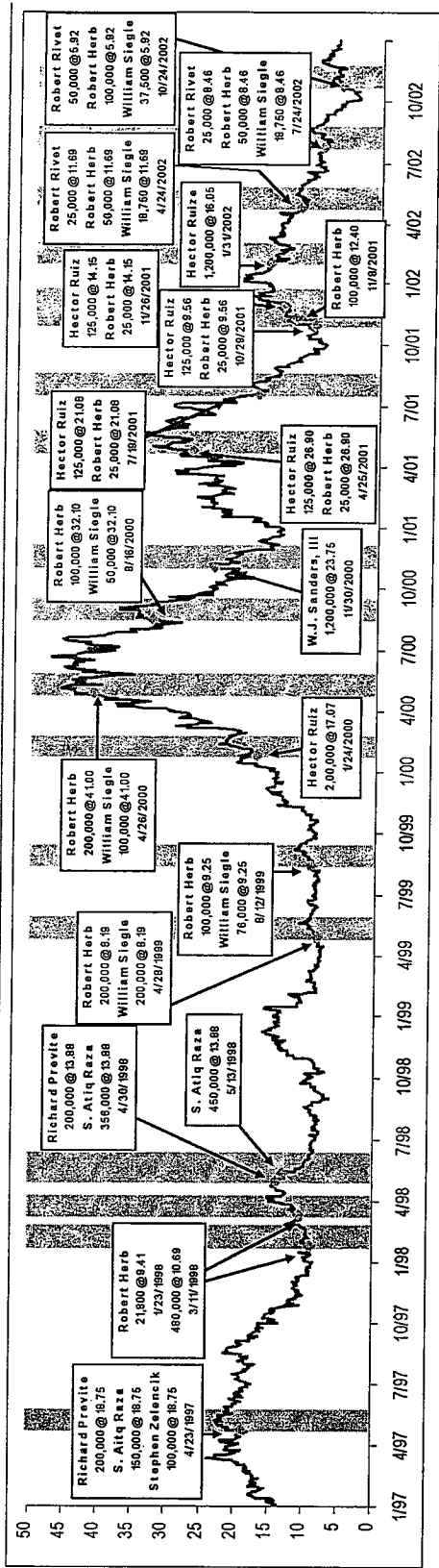


Chart 10: AMD 1997 Detail

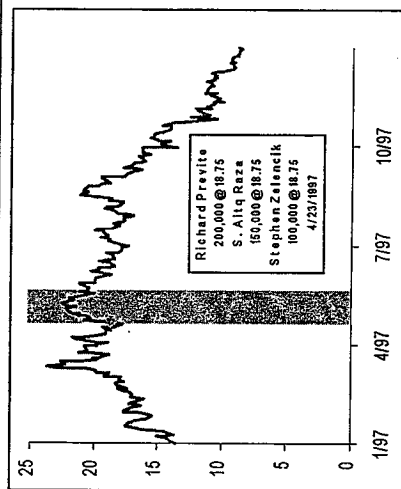


Chart 11: AMD 1998 Detail

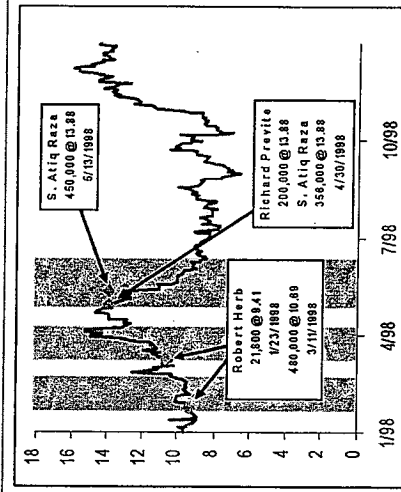
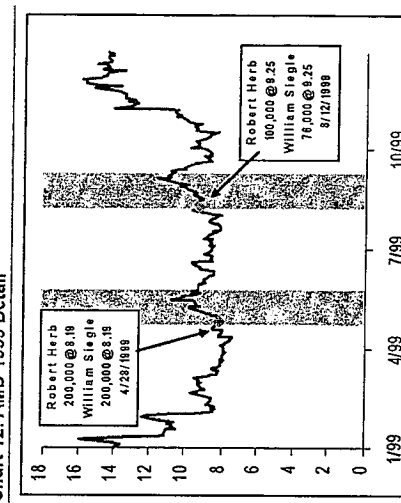


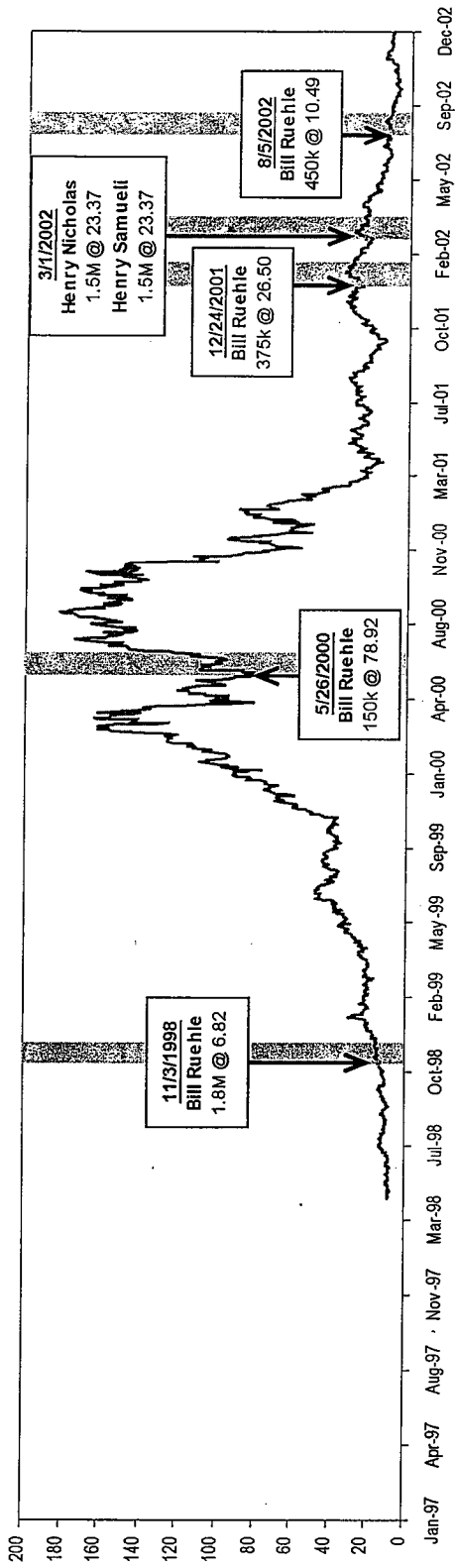
Chart 12: AMD 1999 Detail



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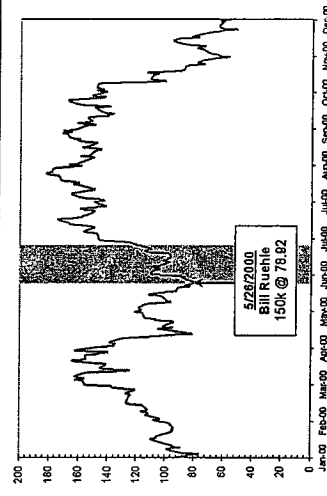
# Broadcom Corp (BRCM; US\$37.20; C-2-9)

Chart 13: BRCM C-Level Stock Grants 1997-2002



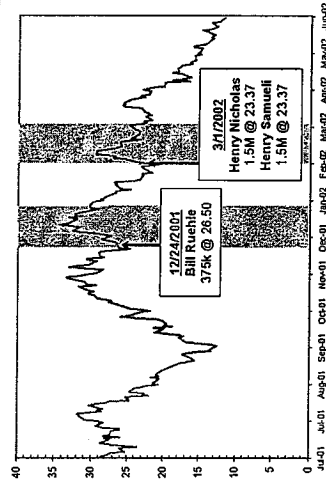
Source: Company Reports, Merrill Lynch

Chart 14: BRCM 2000 Detail



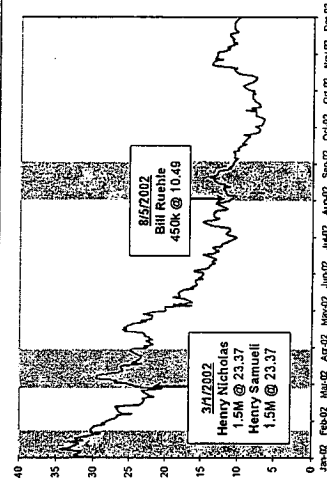
Source: Company Reports, Merrill Lynch

Chart 15: BRCM 2001-2002 Detail



Source: Company Reports, Merrill Lynch

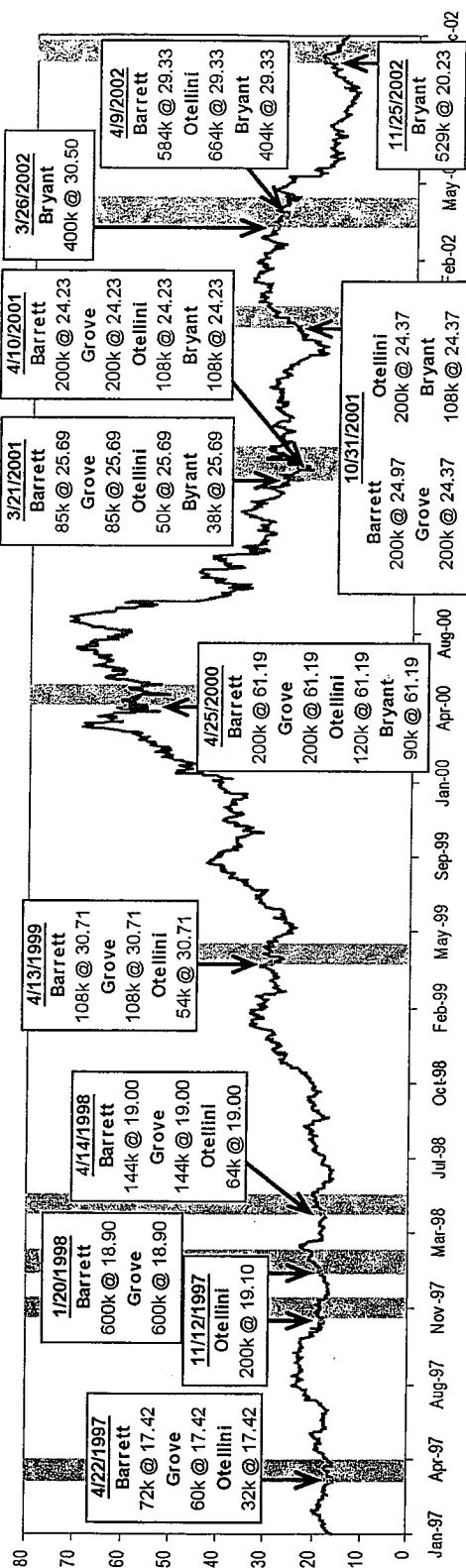
Chart 16: BRCM 2002 Detail



Source: Company Reports, Merrill Lynch

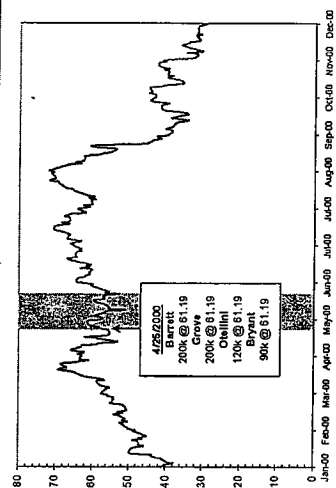
# Intel Corp (INTC; US\$18.36; C-1-7)

Chart 17: INTC C-Level Stock Grants 1997-2002



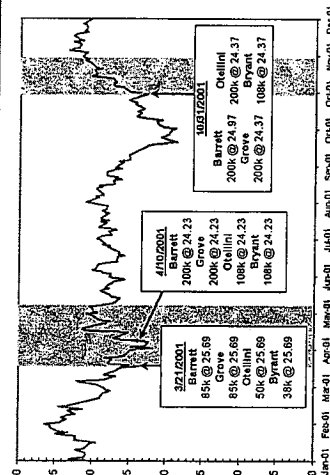
Source: Company Reports, Merrill Lynch

Chart 18: INTC 2000 Detail



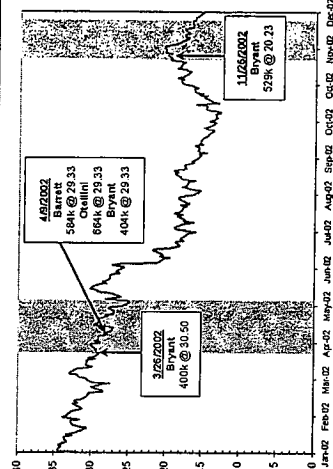
Source: Company Reports, Merrill Lynch

Chart 19: INTC 2001 Detail



Source: Company Reports, Merrill Lynch

Chart 20: INTC 2002 Detail

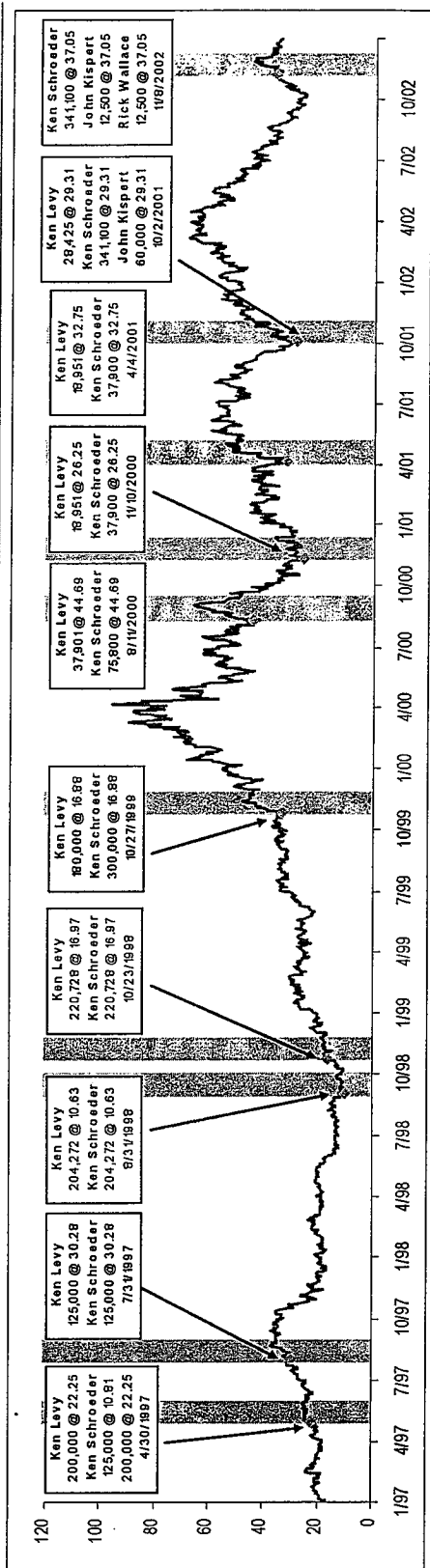


Source: Company Reports, Merrill Lynch



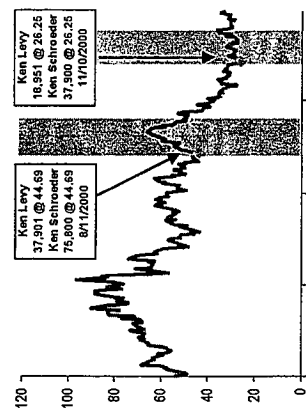
# KLA Tencor (KLAC; US\$45.24; C-1-7)

Chart 21: KLAC C-Level Stock Grants 1997-2002



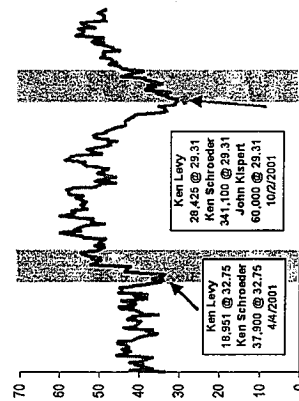
Source: Company Reports, Merrill Lynch

Chart 22: KLAC 2000 Detail



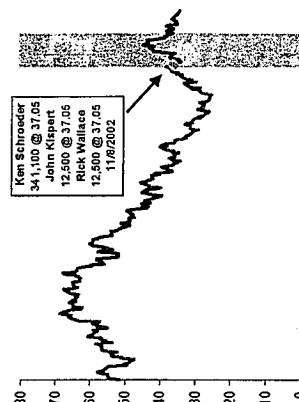
Source: Company Reports, Merrill Lynch

Chart 23: KLAC 2001 Detail



Source: Company Reports, Merrill Lynch

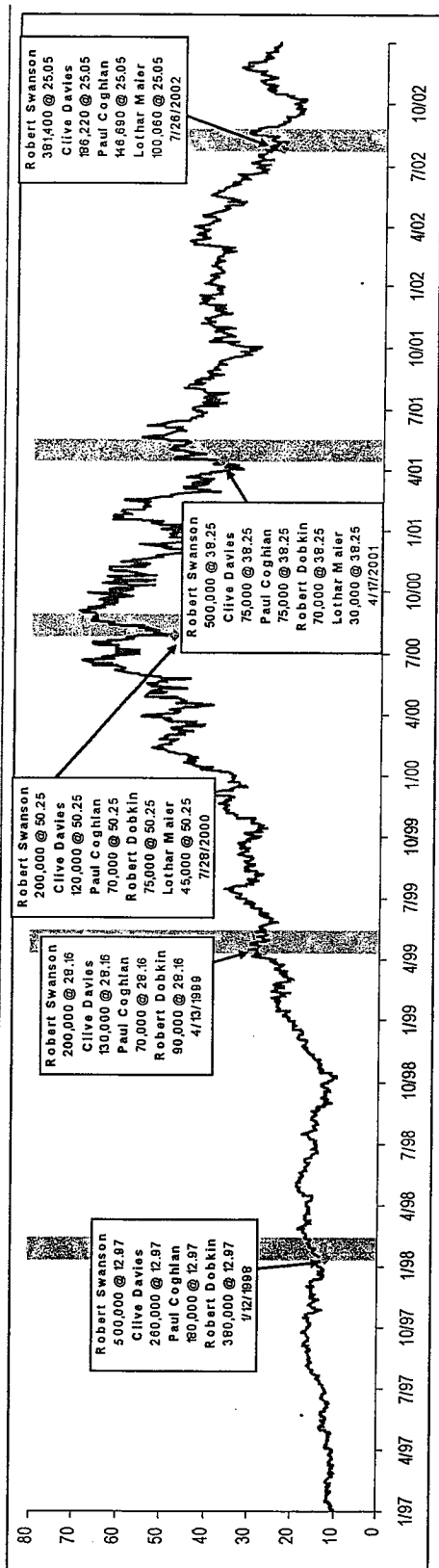
Chart 24: KLAC 2002 Detail



Source: Company Reports, Merrill Lynch

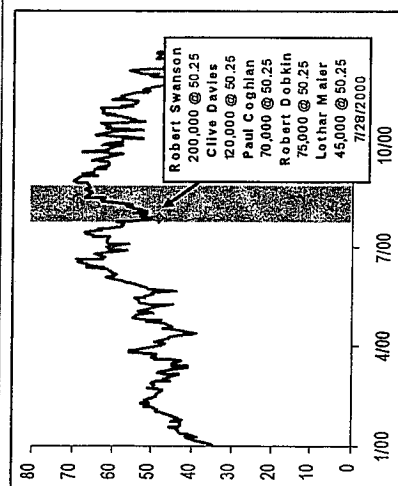
# Linear Technology (LLTC; US\$34.79; C-2-7)

Chart 25: LLTC C-Level Stock Grants 1997-2002



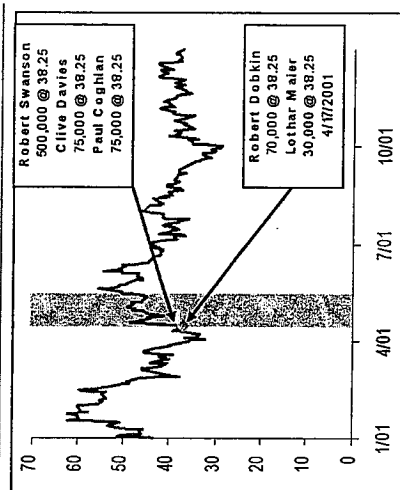
Source: Company Reports, Merrill Lynch

Chart 26: LLTC 2000 Detail



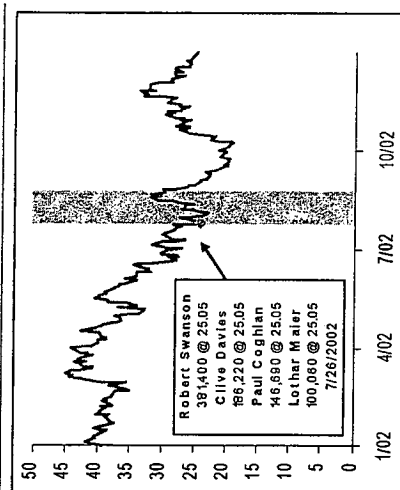
Source: Company Reports, Merrill Lynch

Chart 27: LLTC 2001 Detail



Source: Company Reports, Merrill Lynch

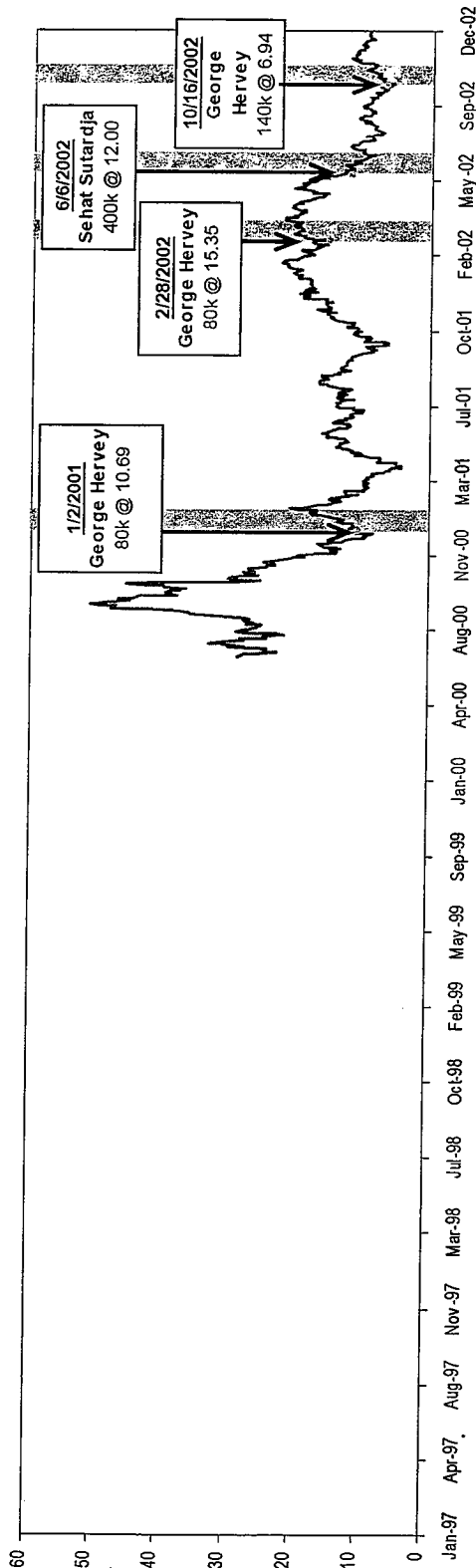
Chart 28: LLTC 2002 Detail



Source: Company Reports, Merrill Lynch

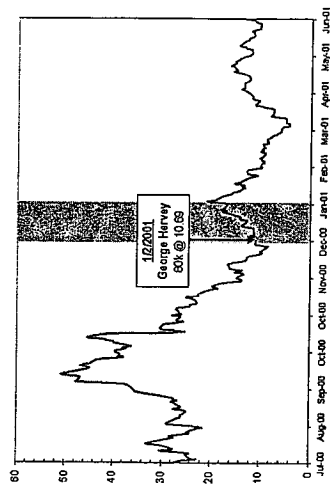
# Marvell Technology Group (MRVL; US\$56.22; C-2-9)

Chart 29: MRVL C-Level Stock Grants 1997-2002



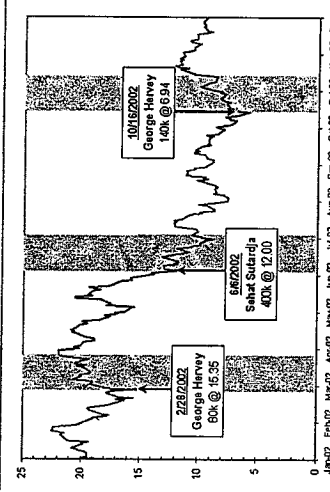
Source: Company Reports, Merrill Lynch

Chart 30: MRVL 2000-2001 Detail



Source: Company Reports, Merrill Lynch

Chart 31: MRVL 2002 Detail



Source: Company Reports, Merrill Lynch

# Maxim Integrated Products (MXIM; US\$32.97; C-1-7)

Chart 32: MXIM C-Level Stock Grants 1997-2002

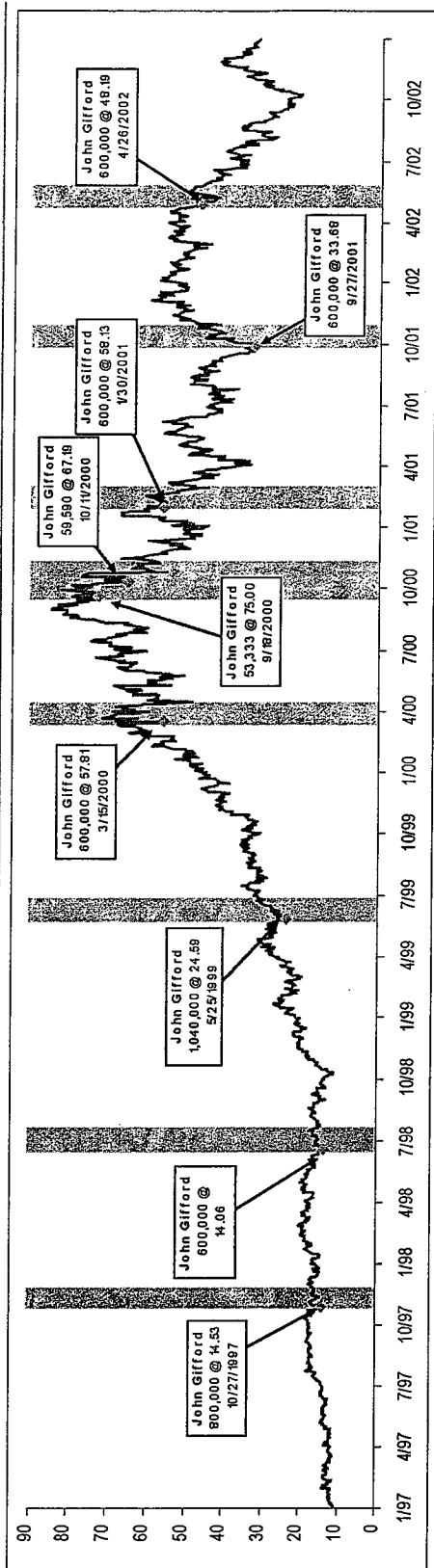


Chart 33: MXIM 1999 Detail

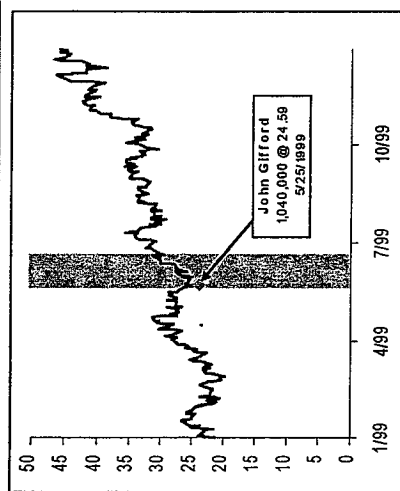


Chart 34: MXIM 2000 Detail

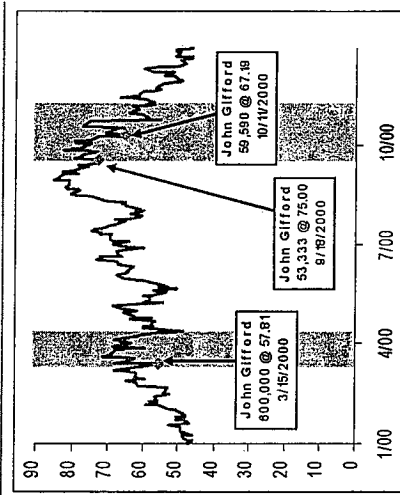
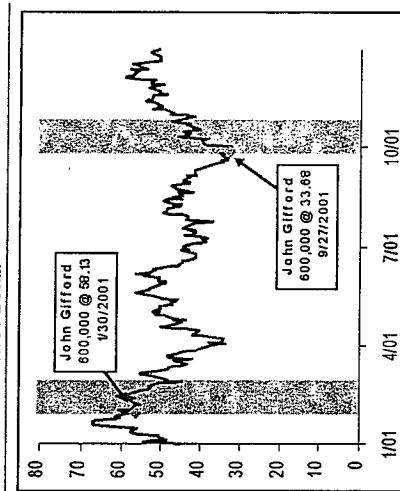
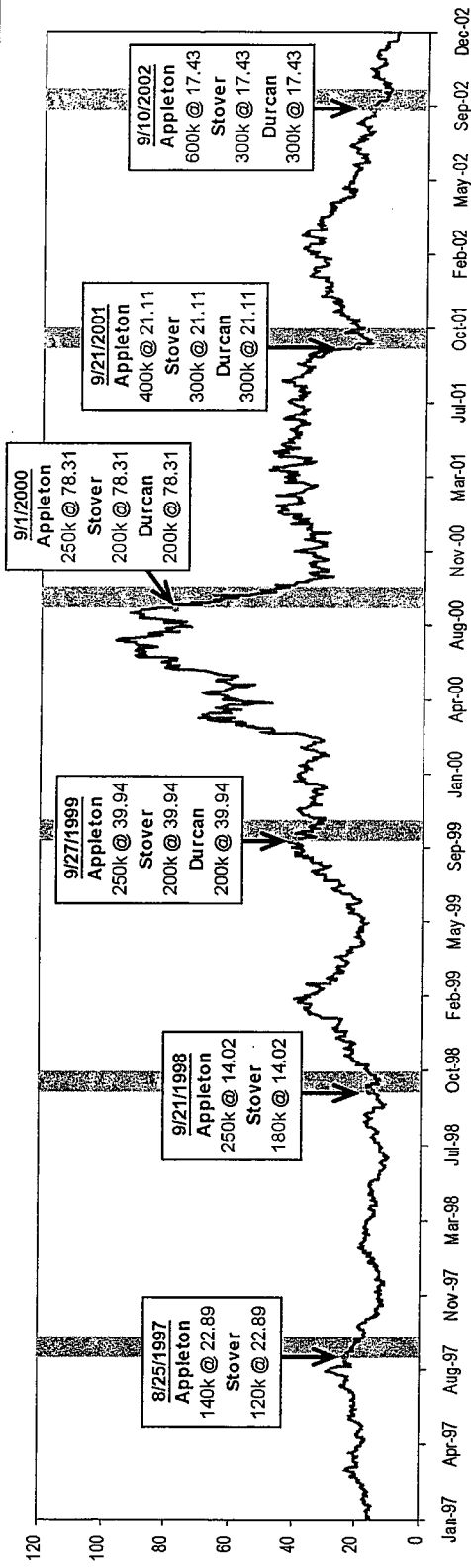


Chart 35: MXIM 2001 Detail



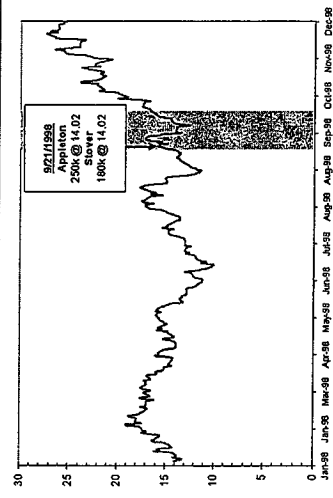
# Micron (MU; US\$15.77; C-1-9)

Chart 36: MU C-Level Stock Grants 1997-2002



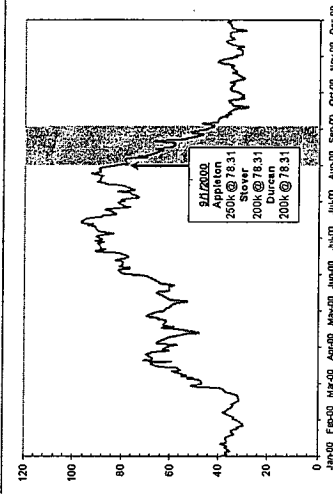
Source: Company Reports, Merrill Lynch

Chart 37: MU 1998 Detail



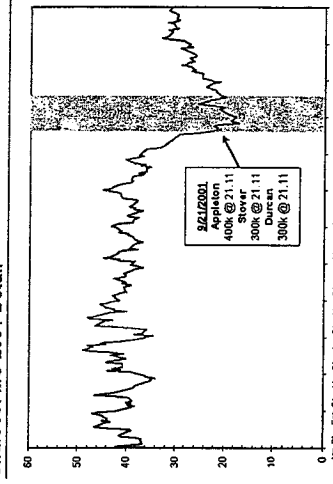
Source: Company Reports, Merrill Lynch

Chart 38: MU 2000 Detail



Source: Company Reports, Merrill Lynch

Chart 39: MU 2001 Detail



Source: Company Reports, Merrill Lynch

# National Semiconductor (NSM; US\$27.62; C-2-9)

Chart 40: NSM C-Level Stock Grants 1997-2002

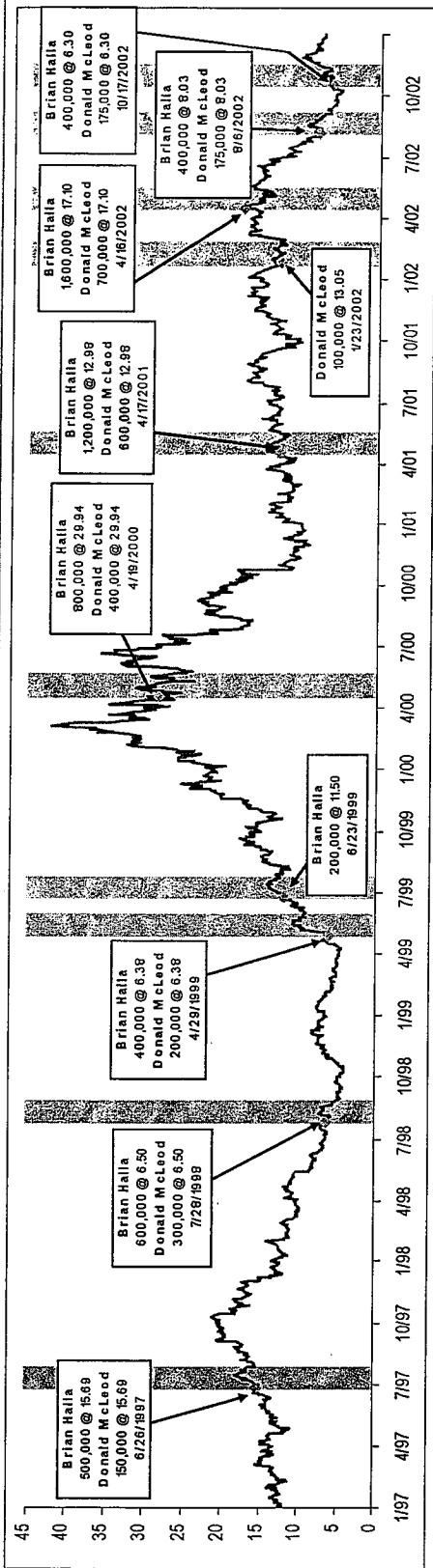


Chart 41: NSM 2000 Detail

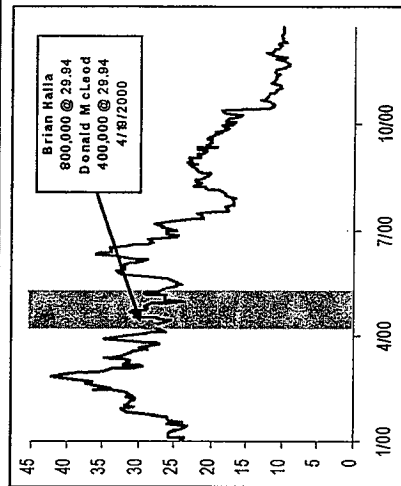


Chart 42: NSM 2001 Detail

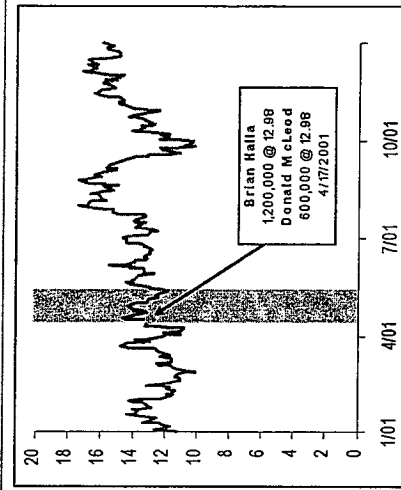
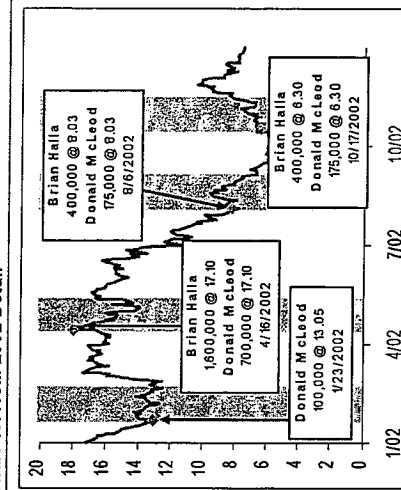
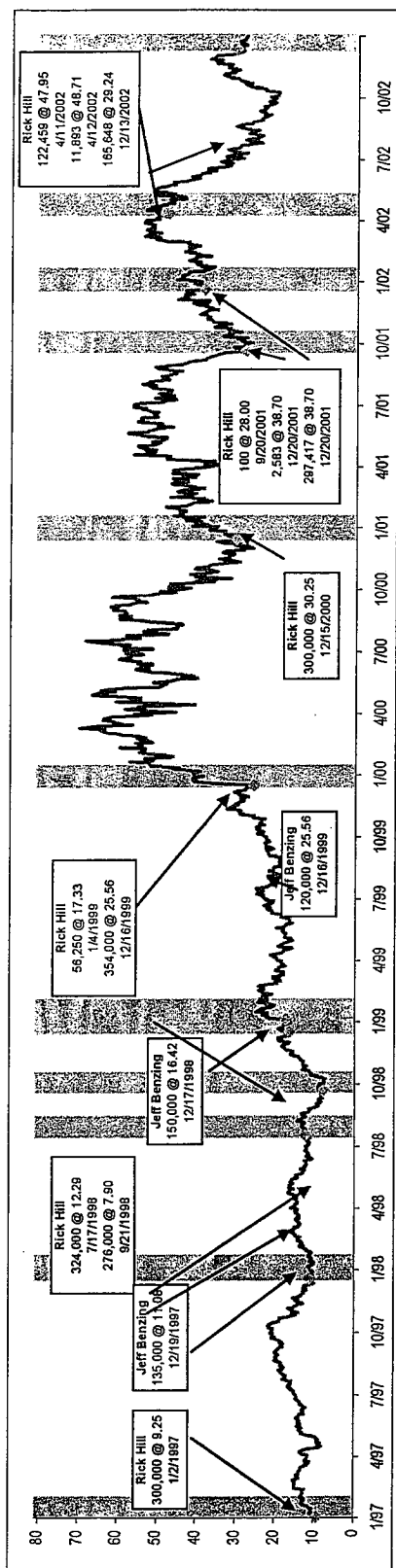


Chart 43: NSM 2002 Detail



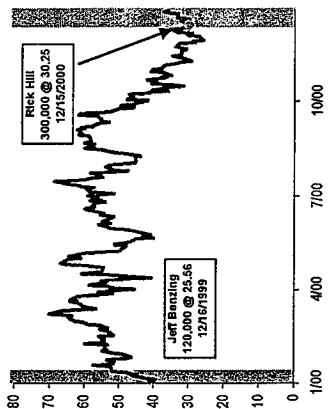
## Novellus Systems (NVLS; US\$23.71; C-1-9)

**Chart 44: NVLS C-Level Stock Grants 1997-2002**



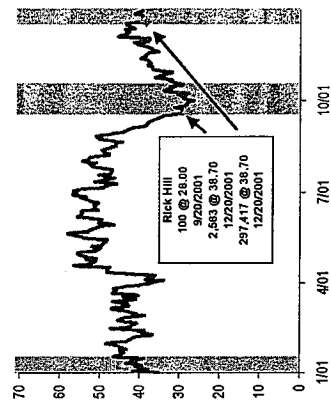
Source: Company Reports, Merrill Lynch

### Chart 45: NVLS 2000 Detail



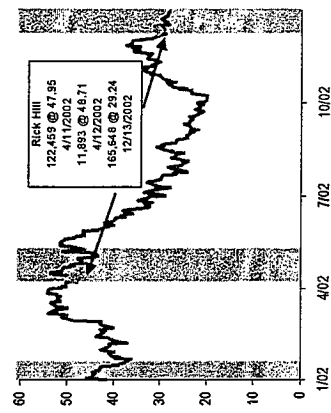
Source: Company Reports, Merrill Lynch

Chart 46: NVLS 2001 Detail



Source: Company Reports, Merrill Lynch

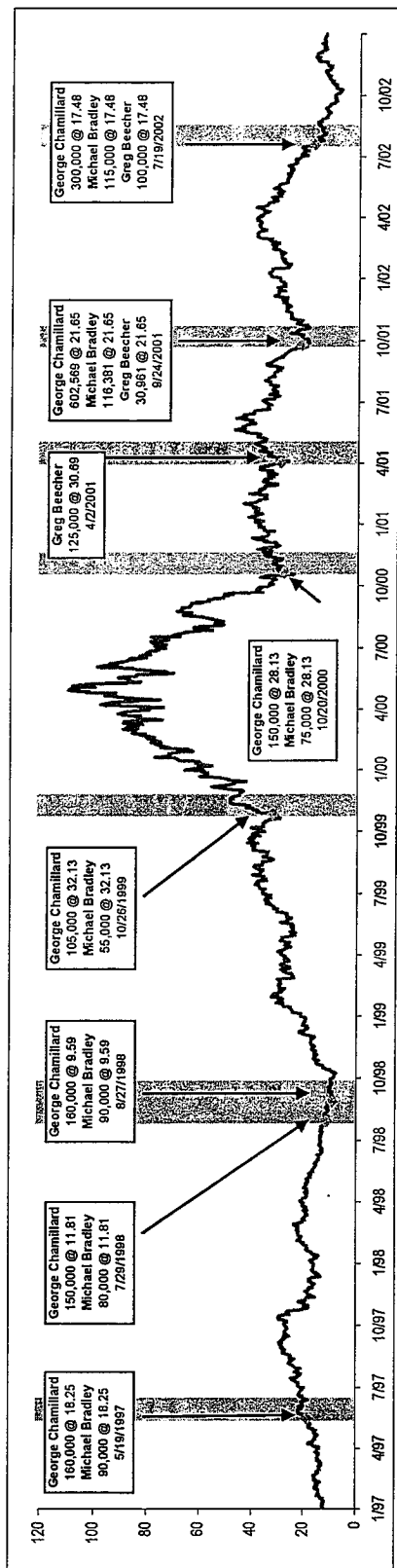
### Chart 47: NVLS 2002 Detail



Source: Company Reports, Merrill Lynch

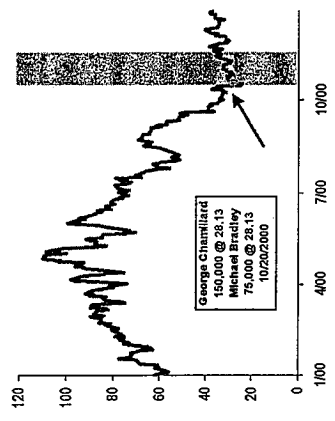
# Teradyne (TER; US\$15.27; C-2-9)

Chart 48: TER C-Level Stock Grants 1997-2002



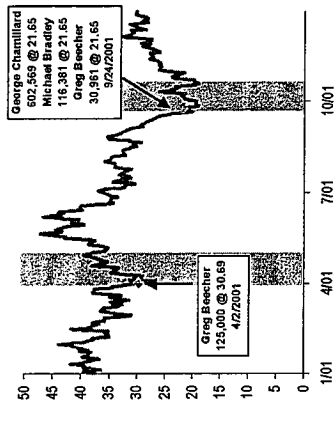
Source: Company Reports, Merrill Lynch

Chart 49: TER 2000 Detail



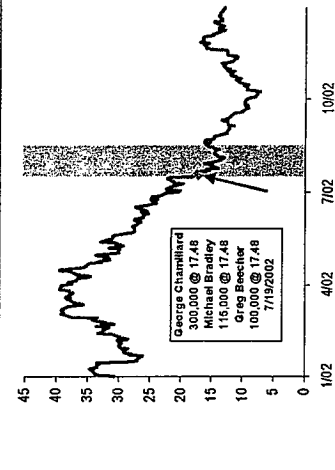
Source: Company Reports, Merrill Lynch

Chart 50: TER 2001 Detail



Source: Company Reports, Merrill Lynch

Chart 51: TER 2002 Detail



Source: Company Reports, Merrill Lynch



# Texas Instruments (TXN; US\$31.97; C-2-7)

Chart 52: TXN C-Level Stock Grants 1997-2002

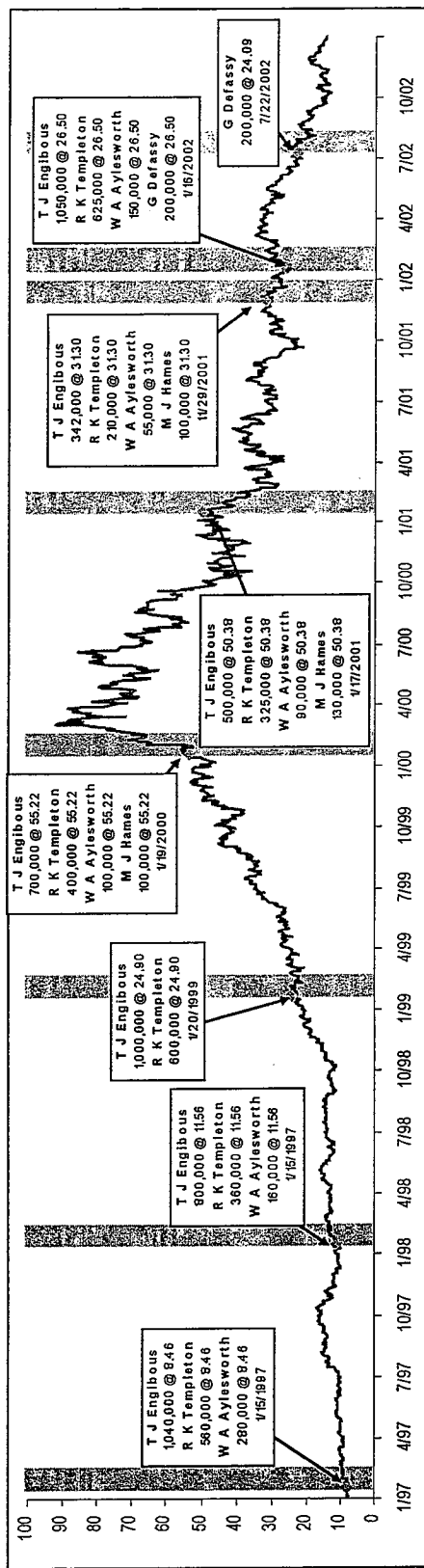


Chart 53: TI 2000 Detail

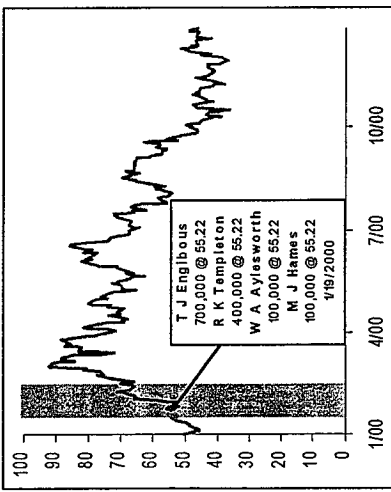


Chart 54: TI 2001 Detail

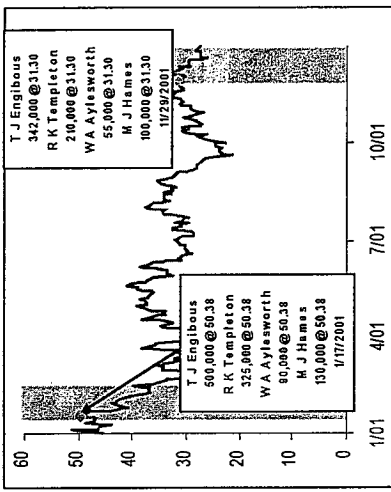
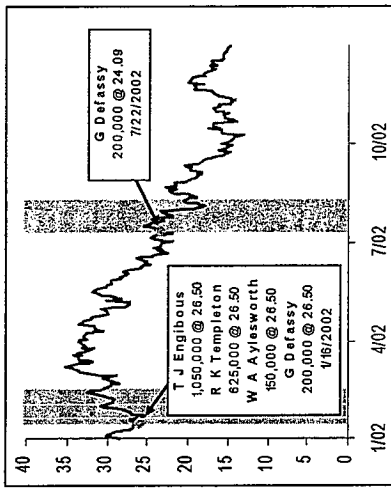
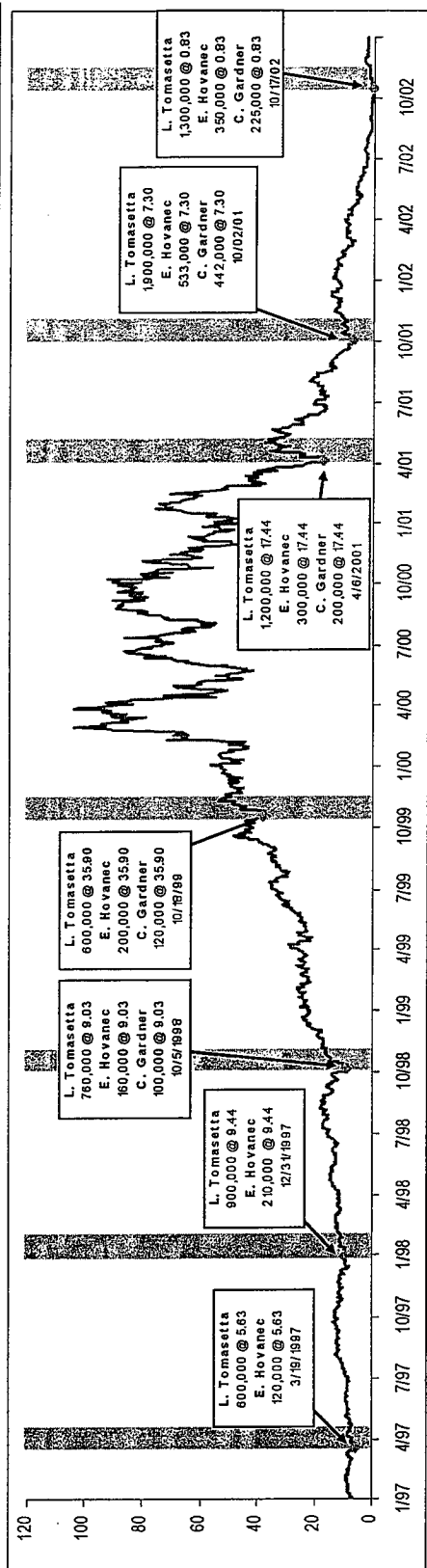


Chart 55: TI 2002 Detail



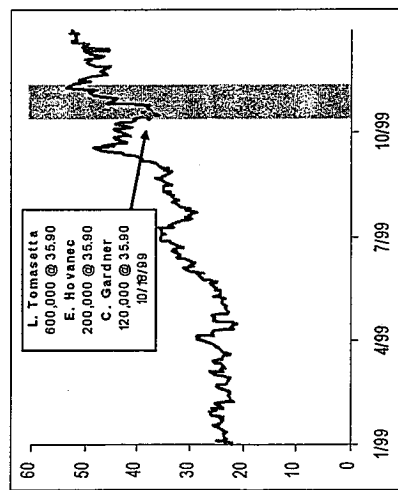
# Vitesse Semiconductor (VTSS; US\$1.77; Review)

Chart 56: VTSS C-Level Stock Grants 1997-2002



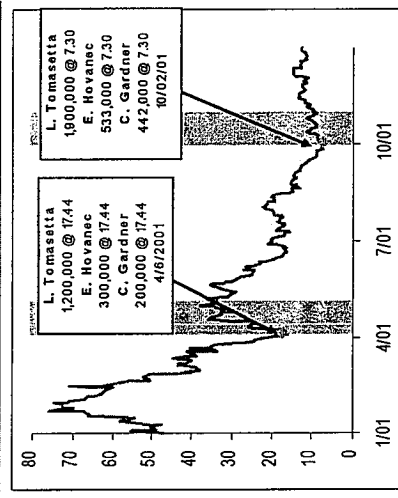
Source: Company Reports, Merrill Lynch

Chart 57: VTSS 1999 Detail



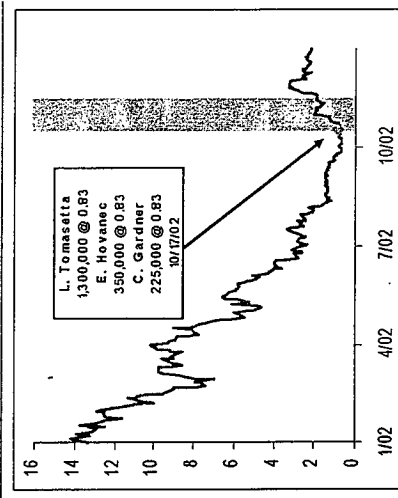
Source: Company Reports, Merrill Lynch

Chart 58: VTSS 2001 Detail



Source: Company Reports, Merrill Lynch

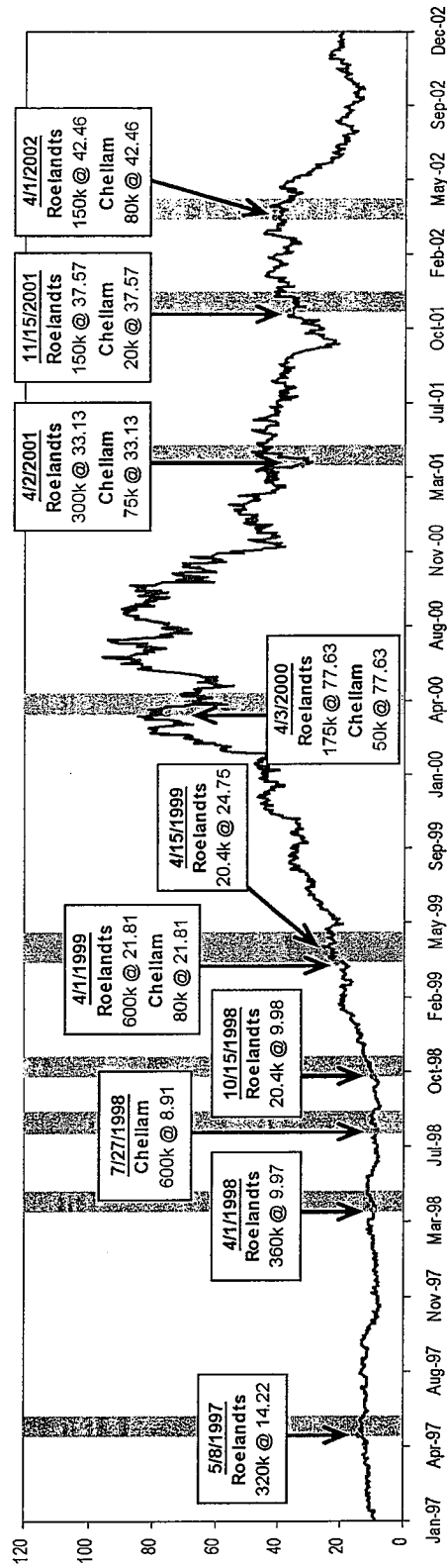
Chart 59: VTSS 2002 Detail



Source: Company Reports, Merrill Lynch

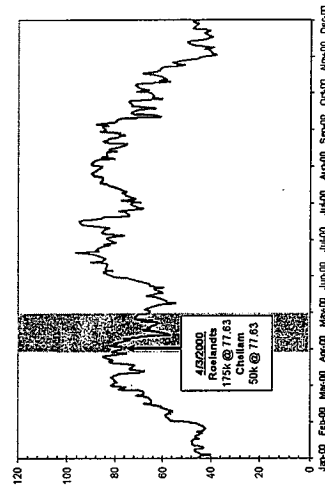
# Xilinx (XLNX; US\$27.10; C-2-7)

Chart 60: XLNX C-Level Stock Grants 1997-2002



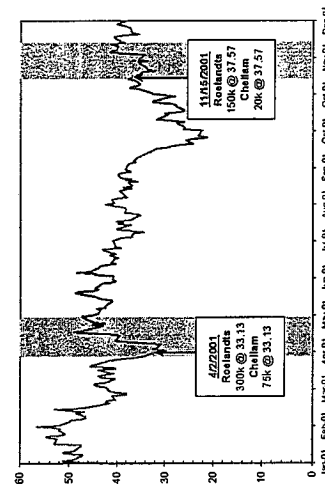
Source: Company Reports, Merrill Lynch

Chart 61: XLNX 2000 Detail



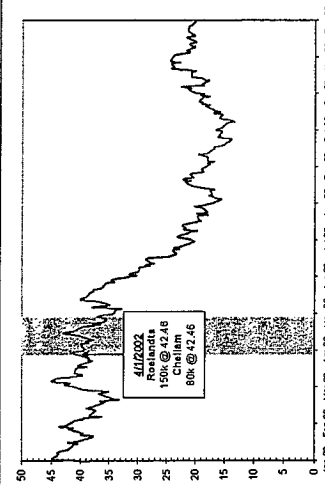
Source: Company Reports, Merrill Lynch

Chart 62: XLNX 2001 Detail



Source: Company Reports, Merrill Lynch

Chart 63: XLNX 2002 Detail



Source: Company Reports, Merrill Lynch

## Price Objective Basis & Risk

### Altera (ALTR; US\$18.73; C-1-9)

Our price objective of \$24 is supported by our long term returns model. With the advent of FAS123 we are focusing more heavily on cash flow as we believe the standard poses substantial comparability problems for companies within our sector. On forecasted free cash flow, we think Altera is attractively valued at 21x. The main risk to our Buy recommendation and price target is unexpected weakness in demand from the communications and industrial & automotive markets, which combined make up over 70% of Altera's total sales. We also note that there is now additional risk associated with the fact that the Altera is unable to make required filings with the SEC on a timely basis.

### Intel (INTC; US\$18.36; C-1-7)

Our price objective of \$25 for Intel is close to the normalized value of \$23 and far below the stretch-high value of \$33 suggested by our return on operating capital model. We are valuing the stock on 2007 earnings power at this point. Looking into 2007, we believe that the company has substantially more earnings power than the street realizes, and we note that on our \$1.32 earnings estimate the \$25 price objective represents a 19x earnings multiple, which we regard as reasonable. The main risk factors to our price target and recommendation are slower demand in the PC business and the possibility of excess manufacturing capacity problems at Intel, which could cut more pressure on profitability than we have anticipated.

### KLA Tencor (KLAC; US\$45.24; C-1-7)

We believe the stock should attain a premium over the 20x P/E that semiconductor capital equipment companies typically trade at during growth periods of at least 21-22x on forward year estimates. If the stock achieves this on our Fiscal 2007 (roughly 12 months forward EPS) GAAP EPS estimate of \$2.80, our \$60 price target should be achievable in the next 12 months.

The timing and strength of a semiconductor industry recovery and rate of capital investment by KLAC's customers are difficult to predict. Competitive pressures and new product execution risks exist. The timing of final acceptance of shipments by customers can also cause volatility. Finally, there is no guarantee that past valuation metrics will be reliable predictors of future valuation, or that the stock will achieve our valuation target.

### Maxim (MXIM; US\$32.97; C-1-7)

Our price objective of \$49 is supported by our mid-cycle fair value model. Despite some risk in the company's ability to meet near-term estimates, we are comfortable with on longer-term assumptions of 17% top-line growth in the intermediate term, and 13% top-line growth in the long-term. We have no reason to believe that Maxim cannot maintain its operating margin in the 43-45% range. The risks to our earnings estimates, recommendation and price objective are unexpected fluctuations in end market demand, especially in the notebook, industrial, and communication end markets. Maxim appears positioned relatively well from a competitive perspective, but the highly competitive nature of the high performance analog market presents additional risks.

### Micron (MU; US\$15.77; C-1-9)

At our \$20 price objective, Micron would be trading on 13x our FY07 GAAP earnings estimate of \$1.60. Forecasting earnings Micron is notoriously tough, however, and we think the more relevant metric is EV/revenue. At \$20, the stock

would be on 2.3x EV/2006 revenue, still towards the low end of the historic range. If Micron manages to move towards 10% market share in NAND the target is conservative. Micron competes in the most volatile segment of the semiconductor business –the memory market. Forecasting earnings for Micron is difficult even by the standards of the semiconductor business, and small variations in market pricing can lead to large changes in earnings estimates. The volatility of the business is the most significant factor associated with our Buy recommendation and price objective.

#### **Novellus (NVLS; US\$23.71; C-1-9)**

Novellus has the potential to expand margins more dramatically than its peers in 2006 as it recovers from execution issues on new product introductions in 2005. The margin expansion means the company's earnings growth could outperform peers in the next 1-2 years. We believe NVLS makes an attractive risk/reward stock given that the large cap semiconductor equipment peers currently trade at 2.3x EV/2007 sales vs. NVLS trading at 1.6x near historical troughs. As NVLS continues to execute on its margin goals, we believe the stock can trade toward 2.3x EV/sales a more typical historical level during growth periods, making our \$34 price target achievable.

Risks remain the timing and strength of a semiconductor industry recovery and customers rate of capital investment. Execution on manufacturing, cost reduction, new product introductions and therefore on margin goals are risks to reaching earnings forecasts and therefore price objectives. Competitive price pressure, technology or products that displace or change market opportunities are risks as well.

#### **Analyst Certification**

We, Joe Osha, Brett Hodess, Thomas Diffely, CFA and Srini Pajjuri, hereby certify that the views each of us has expressed in this research report accurately reflect each of our respective personal views about the subject securities and issuers. We also certify that no part of our respective compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

22 May 2006

## Important Disclosures

### Investment Rating Distribution: Technology Group(as of 31 Mar 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	94	39.33%	Buy	22	23.40%
Neutral	135	56.49%	Neutral	20	14.81%
Sell	10	4.18%	Sell	2	20.00%

### Investment Rating Distribution: Global Group(as of 31 Mar 2006)

Coverage Universe	Count	Percent	Inv. Banking Relationships*	Count	Percent
Buy	1145	40.29%	Buy	393	34.32%
Neutral	1474	51.86%	Neutral	430	29.17%
Sell	223	7.85%	Sell	44	19.73%

\* Companies in respect of which MLPF&S or an affiliate has received compensation for investment banking services within the past 12 months.

**FUNDAMENTAL EQUITY OPINION KEY:** Opinions include a Volatility Risk Rating, an Investment Rating and an Income Rating. **VOLATILITY RISK RATINGS**, indicators of potential price fluctuation, are: A - Low, B - Medium, and C - High. **INVESTMENT RATINGS**, indicators of expected total return (price appreciation plus yield) within the 12-month period from the date of the initial rating, are: 1 - Buy (10% or more for Low and Medium Volatility Risk Securities - 20% or more for High Volatility Risk securities); 2 - Neutral (0-10% for Low and Medium Volatility Risk securities - 0-20% for High Volatility Risk securities); 3 - Sell (negative return); and 6 - No Rating. **INCOME RATINGS**, indicators of potential cash dividends, are: 7 - same/higher (dividend considered to be secure); 8 - same/lower (dividend not considered to be secure); and 9 - pays no cash dividend.

Price charts for the equity securities referenced in this research report are available at <http://www.ml.com/research/pricecharts.asp>, or call 1-888-ML-CHART to have them mailed.

MLPF&S or one of its affiliates acts as a market maker for the securities recommended in the report: Advanced Micro, Altera Corp, Applied Material, Broadcom Corp, Freescale, Intel, KLA-Tencor, Linear Tech, Marvell Tech, Maxim Integrated, Micron Tech, Natl Semi, Novellus, Teradyne, Texas Instrument, Xilinx.

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# SENATE JOURNAL

—1989—

VOLUME 2

REGULAR SESSION

FIRST AND SECOND SPECIAL SESSIONS  
FIFTY-FIRST LEGISLATURE

## STATE OF WASHINGTON

AT

### OLYMPIA, the State Capitol

1989 Regular Session Convened January 9, 1989  
Adjourned Sine Die April 23, 1989

1989 First Special Session  
Convened April 24, 1989  
Adjourned Sine Die May 10, 1989

1989 Second Special Session  
Convened May 17, 1989  
Adjourned Sine Die May 20, 1989

Compiled, Edited and Indexed by  
GORDON A. GOLOB, Secretary of the Senate



MARY WILEY  
Minute and Journal Clerk

JOEL PRITCHARD, President of the Senate  
ALAN BLUECHEL, President Pro Tempore  
ELLEN CRASWELL, Vice President Pro Tempore

PA:118

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## MESSAGES FROM THE HOUSE

Mr. President:  
The Speaker has signed SENATE CONCURRENT RESOLUTION NO. 8427, and the same is herewith transmitted.

May 20, 1989

Mr. President:  
The Speaker has signed HOUSE CONCURRENT RESOLUTION NO. 4423, and the same is herewith transmitted.

May 20, 1989

ALAN THOMPSON, Chief Clerk

Mr. President:  
The Speaker has signed HOUSE CONCURRENT RESOLUTION NO. 4424, and the same is herewith transmitted.

ALAN THOMPSON, Chief Clerk

Mr. President:  
The Speaker has signed HOUSE CONCURRENT RESOLUTION NO. 4423, and the same is herewith transmitted.

May 20, 1989

ALAN THOMPSON, Chief Clerk

## SIGNED BY THE PRESIDENT

The President signed:  
HOUSE CONCURRENT RESOLUTION NO. 4423.

## SIGNED BY THE PRESIDENT

The President signed:  
HOUSE CONCURRENT RESOLUTION NO. 4424.

## RETURN OF BILLS TO HOUSE OF REPRESENTATIVES

Under the provisions of HOUSE CONCURRENT RESOLUTION NO. 4423, the Senate returned the following bills to the House of Representatives:  
ENGROSSED SUBSTITUTE HOUSE BILL NO. 1294,  
ENGROSSED HOUSE BILL NO. 1360,  
ENGROSSED SUBSTITUTE HOUSE BILL NO. 1825,  
ENGROSSED SUBSTITUTE HOUSE BILL NO. 2198.

## MOTION

On motion of Senator Newhouse, the Senate Journal for the fourth day of the 1989 Second Special Session of the Fifty-first Legislature was approved.

## MOTION

At 5:53 p.m., on motion of Senator Newhouse, the 1989 Second Special Session of the Fifty-first Legislature adjourned SINE DIE.

JOEL PRITCHARD, President of the Senate.  
GORDON A. GOLOB, Secretary of the Senate.

## APPENDIX A

## COMMENTS

WASHINGTON BUSINESS  
CORPORATION ACT

Prepared by

Corporate Act Revision Committee  
of the Washington State Bar Association

(See Senate Bill No. 5583, page 379)

The purpose of Proposed section 7.30 is not to impose narrow or technical requirements on voting trusts. For example, a voting trust that by its terms extends beyond the 10-year maximum should be treated as being valid for the maximum permissible term of 10 years.

Proposed subsection 7.30(c) permits a voting trust to be extended for additional terms of not more than 10 years commencing with the date the first shareholder signs the extension agreement. Shareholders who do not agree to an extension are entitled to the return of their shares upon the expiration of the original term.

#### Section 7.31 Voting Agreements.

Proposed subsection 7.31(a) explicitly recognizes agreements among two or more shareholders as to the voting of shares and makes clear that these agreements are not subject to the rules relating to a voting trust. These agreements are often referred to as "pooling agreements." The only formal requirements are that they be in writing and signed by all the participating shareholders; in other respects their validity is to be judged as any other contract. See generally *Winsor v. Commonwealth Coal Co.*, 63 Wash. 62 (1911). They are not subject to the 10-year limitations applicable to voting trusts.

Proposed subsection 7.31(b) provides that voting agreements may be specifically enforceable. A voting agreement may provide its own enforcement mechanism, as by the appointment of a proxy to vote all shares subject to the agreement; the appointment may be made irrevocable under Proposed section 7.22. If no enforcement mechanism is provided, a court may order specific enforcement of the agreement and order the votes cast as the agreement contemplates. To the extent that this result is contrary to *Gleason v. Earles*, 78 Wash. 491 (1914) (holding specific performance would not be ordered where the voting agreement concerned shares of a bank), that case would be overruled by the Proposed section. This section recognizes that damages are not likely to be an appropriate remedy for breach of a voting agreement, and also avoids the result reached in *Ringling Bros. Barnum & Bailey Combined Shows v. Ringling*, 53 A.2d 441 (Del. 1947), where the court held that the appropriate remedy to enforce a pooling agreement was to refuse to permit any voting of the breaching party's shares.

#### Section 7.40 Procedure in Derivative Proceedings.

Proposed section 7.40 deals with the procedural requirements applicable to derivative suits. A great deal of controversy has surrounded the derivative suit, and widely different perceptions as to the value and efficacy of this litigation continue to exist. On the one hand, the derivative action has historically been the principal method of challenging allegedly improper, illegal, or unreasonable action by management. On the other hand, it has long been recognized that the derivative suit may be instituted more with a view to obtaining a settlement favorable to the plaintiff and the plaintiff's attorney than to righting a wrong to the corporation (the so-called "strike suit").

Old RCW 23A.08.460, and similar statutes in many states, imposed a series of procedural requirements designed in part to deter or prevent strike suits. Fed. R. Civ. P. 23.1, and Wash. R. Civ. P. 23.1, also impose procedural requirements on derivative litigation brought in federal and state courts, respectively. There has thus been a great deal of experience with procedural devices to control abuses of the derivative suit. Proposed section 7.40 reflects a reappraisal of these devices in light of major developments in corporate governance, the public demand for corporate accountability, and the corporate response in the form of greater independence and sense of responsibility in boards of directors. It is also adopted with the expectation that future developments (e.g., a new Revised Model Act provision; an ALL provision) will cause reexamination of the provision in the near future.

#### 1. PROCEDURAL REQUIREMENTS

The procedural requirements imposed by Proposed section 7.40 are as follows:

a. The plaintiff may be either a registered or beneficial owner of shares held by a nominee in the beneficial owner's behalf

Many statutes, and old RCW 23A.08.460, required the plaintiff to be a shareholder "of record." This limiting requirement was dropped, in light of the widespread use of street name or nominee ownership of shares. At the same time, it was determined that, in accord with old RCW 23A.08.460, the beneficial owner of shares held in a voting trust should also be permitted to serve as a plaintiff in a derivative suit. These changes were accomplished by the addition of a special definition of "shareholder" in subsection (e) to broaden the definition of that term in section 1.40.

b. The plaintiff must have been an owner of shares at the time of the transaction in question

The statutes of many states and old RCW 23A.08.460 have long imposed a "contemporaneous ownership" rule, i.e., the plaintiff must have been an owner of shares at the time of the transaction in question. This rule has been criticized as being unduly narrow and technical and unnecessary to prevent the transfer or purchase of lawsuits. A few states, particularly California, Cal. G.C.L. section 800(B), have relaxed this rule to the extent of allowing some subsequent purchasers of shares to be plaintiffs in limited circumstances.

The decision to retain the contemporaneous ownership rule in Proposed section 7.40 was based primarily on the view that it was simple, clear, and easy to apply while the California approach might encourage litigation on peripheral issues like the extent of the plaintiff's knowledge of the transaction in question when the plaintiff acquired the plaintiff's shares. Further, there has been no persuasive showing that the contemporaneous ownership rule has prevented the litigation of substantial suits since there appear to be many persons who might qualify as plaintiffs to bring suit even if subsequent purchasers are disqualified.

c. The complaint must be verified

Proposed subsection 7.40(b) requires the complaint in a derivative suit to be verified, i.e., sworn to. Compare Fed. R. Civ. P. 23.1; Wash. R. Civ. P. 23.1; *Surowitz v. Hilton Hotels Corp.*, 383 U.S. 363 (1966). This requirement provides some protection against groundless litigation without deterring suits brought in good faith.

d. Option holders and convertible debenture holders are not permitted to sue

Arguments may be made that long-term creditors and investors with the privilege of becoming shareholders by the exercise of options or conversion rights should be permitted to bring derivative suits. These arguments, however, appear to involve the substantive rights of these various classes of investors more than the procedures required for the assertion of derivative rights on behalf of the corporation. See, e.g., *Harff v. Kerkorian*, 324 A.2d 215 (Del. Ch. 1974), rev'd in part, 347 A.2d 133 (Del. 1975). Therefore, Proposed subsection 7.40(a) does not permit option holders or convertible debenture holders to serve as derivative plaintiffs.

e. There must be prior notice and demand on directors in most circumstances

The purpose of a demand on the board of directors is to stimulate the board of directors to enforce the rights of the corporation on its own. Modern trends in corporate governance—particularly the increasing number of outside directors and greater director sensitivity to their roles in the corporation and to the possibility of personal liability—improve the likelihood that the board of directors will weigh carefully the shareholder's demand. Therefore, Proposed subsection 7.40(b) requires an allegation with particularity of the demand made, if any, on the board of directors. On the other hand, there may be circumstances showing that a demand on the board of directors would be useless, and in those circumstances it should be sufficient to allege the reasons why the plaintiff did not make the demand.

Of itself, the rejection by the board of directors of the shareholder's demand neither permits nor precludes the shareholder's suit. See paragraph 2a. below.

f. There need be no prior notice to or demand on shareholders

Rule 23.1 of the Fed. R. Civ. P. (and Wash. R. Civ. P. 23.1) requires that, in addition to a demand on the board of directors, a demand be made on shareholders "if necessary." The statutes of a number of states, including California and New York, require demands only on boards of directors.

Although a demand on shareholders seems generally consistent with the broad doctrine of requiring exhaustion of all internal avenues of relief before commencement of suit, the board of directors, not the shareholders, is charged with governance of the corporation, including the commencement and management of

litigation. Further, to require a demand on shareholders would virtually require the plaintiff to engage in a preliminary proxy contest and, in the case of publicly held corporations, would greatly increase the cost of filing all derivative suits, discouraging even legitimate cases.

For these reasons, it was concluded that the requirement of a demand on shareholders would add uncertainty, expense, and delay without commensurately improving the prospects of resolving the substantive issues.

g. A court may stay a derivative suit while the board of directors investigates. The last sentence of Proposed subsection 7.40(b) provides that if the corporation undertakes an investigation, the court may stay the proceeding until the investigation of the charges made in the demand or complaint is completed. The purpose of this stay is to preserve the right of the board of directors to consider whether or not to seek to enforce on its own the corporation's claim.

h. Plaintiffs are not required to post bond as security for expenses. Old RCW 23A.08.460 paragraph 3 and the statutes of many states required a plaintiff to give security for reasonable expenses, including attorneys' fees, if the plaintiff's holdings of shares did not reach a specified size or value—five percent of the outstanding shares or a value of \$25,000. This requirement has been deleted. The security for expenses requirement, to the extent it was based on the size or value of the plaintiff's holdings rather than on the apparent good faith of the plaintiff's claim, was subject to criticism that it unreasonably discriminated against small shareholders.

The basic policy question with respect to the requirement of a bond for small shareholders is how far to go in protecting the corporation and its officers and directors from suits. The choice is between making the right to sue widely available, without obstacles except in obviously baseless cases, or imposing obstacles in the way of the small shareholder without imposing a similar obstacle in the way of the large shareholder. Moreover, no bond requirement exists for class actions, antitrust cases, or individual actions for personal injury, all of which involve the corporation in substantial expense of defending against suit.

Several states have concluded on the basis of these considerations that the bond requirement for small plaintiffs should be repealed or not adopted.

i. Recovery of reasonable expenses of suit, including attorneys' fees, if suit is brought without good cause

In lieu of the bond requirement, Proposed subsection 7.40(d) provides that on termination of a proceeding the court may require the complainant to pay the defendants' reasonable expenses, including attorneys' fees, if it finds that the proceeding "was commenced without reasonable cause." This test is similar to but not identical with the test utilized in Proposed section 13.31, relating to dissenters' rights, where the standard for award of expenses and attorneys' fees is that dissenters "acted arbitrarily, vexatiously or not in good faith" in demanding a judicial appraisal of their shares. The derivative action situation is sufficiently different from the dissenters' rights situation to justify a different and less onerous test for imposing costs on the plaintiff. The test of Proposed subsection 7.40(d) that the action was brought without reasonable cause is appropriate to deter strike suits, on the one hand, and on the other hand to protect plaintiffs whose suits have a reasonable foundation.

Proposed subsection 7.40(d) does not refer to the award of expenses, including attorneys' fees, to successful plaintiffs. The right of successful plaintiffs in derivative suits to this recovery is so universally recognized, both by statute and on the theory of a recovery of a fund or benefit for the corporation, that specific reference was thought to be unnecessary. The intention is to preserve fully these nonstatutory rights of reimbursement. Therefore, no negative inference should be drawn from Proposed subsection 7.40(d) as to the rights of plaintiffs to reimbursement.

Abuses in the conduct of derivative litigation may occur on the part of defendants and their counsel as well as by plaintiffs and their counsel. Abuses may occur with respect to motions, pleadings, requests for discovery and resistance to discovery when conducted either in bad faith or without good cause. Sanctions to deal with such conduct are not included in this Act because courts possess adequate power to impose appropriate sanctions under rules of civil procedure or the

general equity power of courts. See Roadway Express, Inc. v. Piper, 447 U.S. 752 (1980).

j. Settlement or discontinuance of derivative litigation requires judicial approval

Proposed subsection 7.40(c) follows the Fed. R. Civ. P. 23.1, Wash. R. Civ. P. 23.1, and the statutes of a number of states, including New York and Michigan, and requires that all proposed settlements and discontinuances must receive judicial approval. This requirement seems a natural consequence of the proposition that a derivative suit is brought on behalf of the class of all shareholders and avoids many of the evils of the strike suit by preventing the individual shareholder-plaintiff from settling privately with the defendants.

Proposed subsection 7.40(c) also requires notice to all affected shareholders if the court determines that the proposed settlement may substantially affect the interest of one or more classes of shareholders. Unlike the statutes of some states, however, Proposed subsection 7.40(c) does not address the issue of which party should bear the cost of giving this notice. That is a matter left to the discretion of the court reviewing the proposed settlement.

## 2. ISSUES UNRESOLVED BY PROPOSED SECTION 7.40

Several issues relating to Proposed section 7.40 were reserved for future consideration because it was felt that further experience or experimentation was desirable before their resolution was encapsulated in statutory language. The issues so reserved include the following:

a. Should a decision by the board of directors that maintenance of a derivative suit is against the corporation's interest bar the suit?

The case law concerning the power of the board of directors or of an independent committee of the board to bar a derivative suit without judicial review is in a state of flux. See, e.g., Burks v. Lasker, 441 U.S. 471 (1979); Auerbach v. Bennett, 393 N.E.2d 994 (1979); Zapata Corp. v. Maldonado, 430 A.2d 779 (Del. 1981); Aronson v. Lewis, 473 A.2d 805 (Del. 1984). For the present it should be permitted to continue to develop.

b. Should the method of calculating attorneys' fees be specified?

Courts are today scrutinizing plaintiffs' fees more closely than they have in the past. This trend should be encouraged, and it was therefore concluded that the subject was not appropriate for statutory language at the present time. It is believed that the problem is more acute with respect to plaintiffs' fees recoverable under general principles of derivative litigation than it is under Proposed subsection 7.40(c).

## CHAPTER 8. DIRECTORS AND OFFICERS

### Section 8.01 Requirement For and Duties Of Board of Directors.

Proposed section 8.01 requires that every corporation have a board of directors except that a corporation may dispense with or limit the authority of the board of directors by describing in the articles "who will perform some or all of the duties of a board of directors." Proposed subsection 8.01(c).

Obviously, some form of governance is necessary for every corporation. The board of directors is the traditional form of corporate governance but it need not be the exclusive form. Patterns of management may be tailored to specific needs in connection with family controlled enterprises, wholly or partially owned subsidiaries, or corporate joint ventures. The persons who perform some or all of the duties of the board of directors may be designated "trustees," "agents," or "managers," and they may be selected in ways other than the traditional election by the shareholders. It is necessary, however, that some person or group perform these duties, and the designated persons, while performing them, are subjected to the same duties as directors.

Proposed subsection 8.01(b) states that if a corporation has a board of directors "all corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of," the board of directors. The quoted language is chosen to reflect the role and functions of boards of directors in all varieties of corporations. In a small corporation and in some larger corporations where the board of directors is composed entirely of

### DECLARATION OF SERVICE BY MAIL


I, the undersigned, declare:

1. That declarant is and was, at all times herein mentioned, a citizen of the United States and a resident of the County of San Diego, over the age of 18 years, and not a party to or interested party in the within action; that declarant's business address is 655 West Broadway, Suite 1900, San Diego, California 92101.

2. That on November 14, 2008, declarant served the **APPENDIX IN SUPPORT OF PLAINTIFFS' BRIEF ON CERTIFIED QUESTION** by depositing a true copy thereof in a United States mailbox at San Diego, California in a sealed envelope with postage thereon fully prepaid and addressed to the parties listed on the attached Service List.

3. That there is a regular communication by mail between the place of mailing and the places so addressed.

I declare under penalty of perjury that the foregoing is true and correct. Executed this fourteenth day of November, 2008, at San Diego, California.

  
Terree DeVries

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